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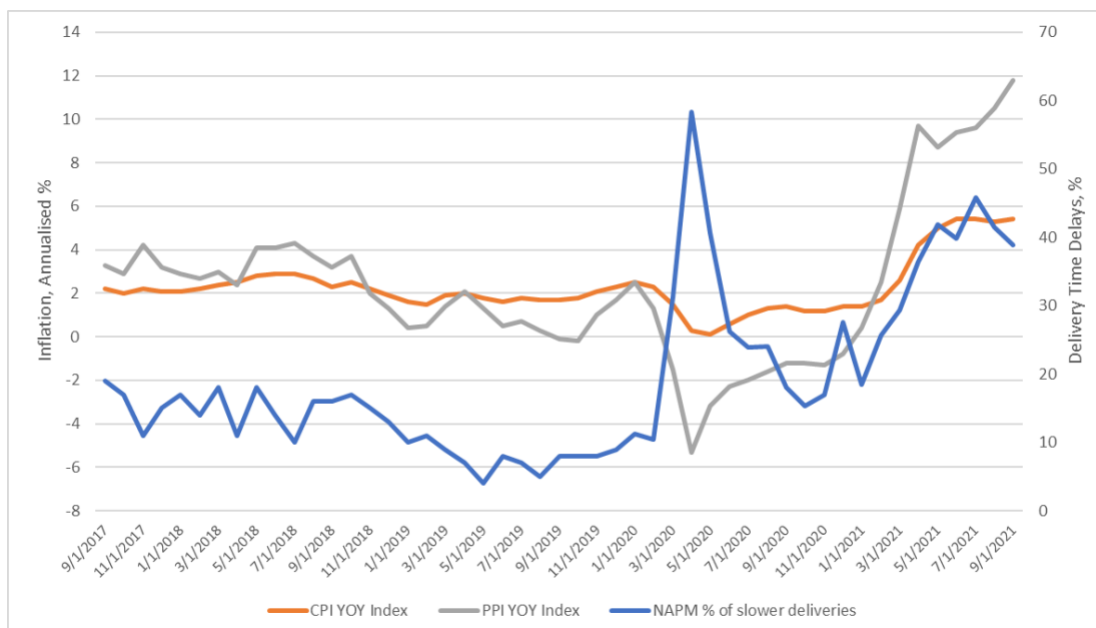
A rocky road to recovery

- **The market is starting to buy the inflation argument**
- **Although Central Banks are still divided, the momentum is growing**
- **Supply chain issues are becoming more visible, and energy price rises might be sticky**
- **Bond markets are far more nervous about the outcome than equities**

The post-COVID recovery is turning out to be a topsy-turvy affair. Global third-quarter data shows the various headwinds still affecting the pace of this recovery and some of the risks that lurk on the horizon. For markets, the non-transitory nature of inflation is becoming an issue, and, more broadly, the drag imposed by the persistence of the delta variant remains obvious.

Several factors are contributing to the perceived risk of inflation. Slower delivery times, as measured by one of the sub-components of the NAPM survey (Chart 1 below), is a pressing one. Both CPI and finished goods PPI have risen to high levels, with the core CPI measure being well above the Fed's 2% target. At the same time, suppliers are struggling to meet delivery targets: upwards of 40% of deliveries arrived late in the US in September, which is very high by historical standards.

Chart 1: Inflation is up, as are delayed deliveries



Source: Bloomberg

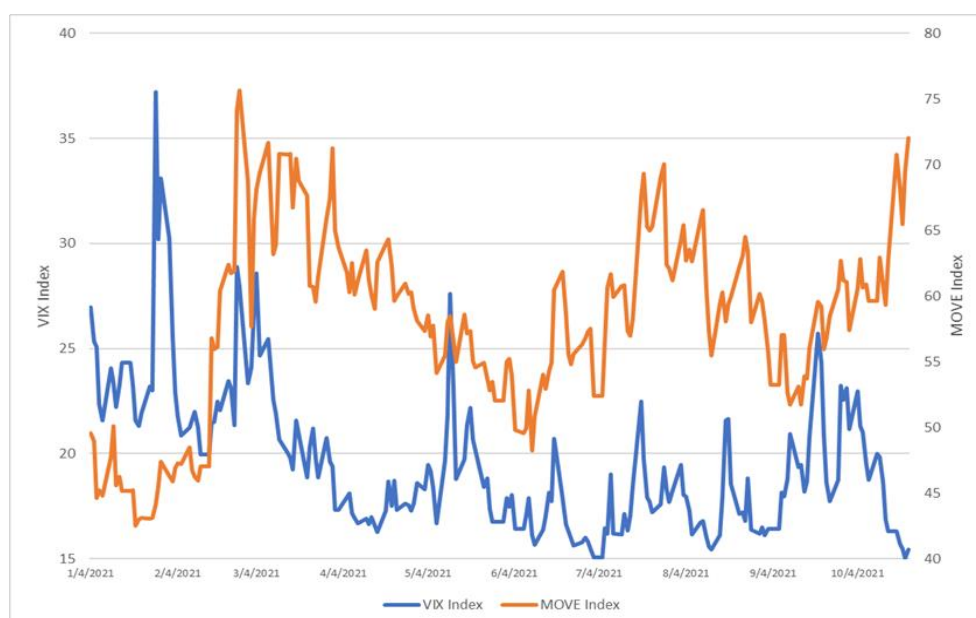
Energy prices rises are not abating: It can sometimes be the case that policymakers turn a blind eye to temporary increases in energy prices. Hiking interest rates in response to short-term price jumps in oil prices is not the done thing. However, the current rise in the broader energy complex is risking follow-through effects into non-energy related prices. Natural gas prices have increased even more, apart from the increases in crude oil (hovering around \$85 per barrel). From the middle of 2020, the near futures contract on natural gas level has jumped to \$5.28 from the recent low of \$1.5. Even the most patient inflation dove will become jittery about the risk of multiplier effects escaping into the broader economy.

Inflation expectations are rising: The broad set of inflation breakeven measures in the fixed income market continues to increase. For example, the most liquid and the simplest one to observe, the US 10Y TIPS implied breakeven rate, closed last week at 2.64%. Even though this is still way below the current core inflation rate of 4%, it is the highest on record since the inception of trading on TIPS securities in 1999.

Central banks are not acting in unison: Major central banks are adopting differing approaches to deal with the challenge of rising inflation. The Fed appears to be following the middle path by signalling the start of tapering by November and a lift-off in rates by mid-2022. Adopting a hawkish stance, the Bank of England has sent out signals that it is looking to begin tightening in response to the surge in inflation in the UK. The market shares the concern by pricing the 10Y breakeven rate at 4.2%, the highest since 1995 and well above the BOE's target rate. The doves in the room are the ECB and the Bank of Japan. The ECB is still committed to a stable policy path. However, it faces market questions about its inflation stance. At the moment, a lift-off in rates is being priced for the end of 2022, six months later than is the case for US rates. The BOJ is unlikely to tweak policy settings any time soon, with inflation not forecast to reach its target of 2% before 2023.

The overall growth trajectory was flattened in Q3, partly due to the deeper impact from the delta variant in major economies. In China, there is an additional drag from the ongoing Evergrande crisis that is keeping the property sector on tenterhooks. Globally, rising energy input costs and supply chain delays have also weighed on growth. Moody's recently estimated real US GDP for the second quarter at 2% year-on-year. That was a serious disappointment compared with the expected 6%, which was the forecast before the highly contagious delta strain spread widely. A slower inventory drawdown was in evidence, driven by the mentioned supply chain difficulties.

Chart 2: Bond market frets while equities chill out



Source: Bloomberg

Bond market volatility is quite elevated: The further path of the delta strain remains a risk, as does the risk of a policy error by the Fed – by leaving policy settings too loose in the face of an inflation surprise. The responses in volatility in the equities and fixed income markets have been very different, as we plot in Chart 2.

Over the past month, 10Y bond yields have risen by about 30 basis points to 1.65%; at the same time, the implied volatility of hedging contracts (MOVE index) on interest rates has spiked to 70. At this level, it is close to the high for the year. It reflects the actual underlying gyrations of the interest rate market and the unease felt by market players who have exposure to losses if rates were to rise quickly. The level of the index reflects the cost of hedging against interest rate movements. Hence, an increase is also indicative of higher demand for insurance.

By contrast, the equity market seems to have gone into a pre-Christmas holiday by comparison, as the much-watched VIX index has dropped to 15, equalling the lowest recorded so far this year. One interpretation is that the equity market is coming to grips with the possibility that interest rates are badly mispriced to the downside compared to any reasonable inflation outcome.

Not stagflation: As the inflation picture clears up, a slow fade in the effects of the pandemic will become evident in economic growth numbers, too. In the US and Europe, Q4 should be up to speed again, with pre-pandemic levels reachable by the middle of 2023. The scenario is thus one of rising interest rates set against the backdrop of trend economic growth. The equity market response thus far suggests a sense of comfort – and alignment – with this outcome.

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