

Transitory or sustained inflation? Monthly Commentary

For wholesale investors only

That is the question that continues to dominate markets. Central banks have been dogged in arguing the former. Richard Clarida of the Federal Reserve, for example, pointed to transitory factors such as base effects and supply chain bottlenecks that are behind the recent uptick in inflation. He expects inflation to return to 2% in 2022 and 2023. There has been little acknowledgment however of the demand side of the story. The extravagant fiscal response in the US caused a surge in disposable income which is still 12% higher than pre-pandemic levels. Money saved in retail deposits (M2) is roughly 20% higher than last year. These factors likely explain why inflationary pressures in the US are much greater than the rest of the developed world, which also faces supply shortages and exaggerated base effects. The latest annual growth of CPI in the US was 4.2%, versus only 1.6% in the EU, 1.5% in the UK, -0.4% in Japan, 3.2% in Canada, and 1.1% in Australia.

The taper conversation will of course continue to grow as the economy recovers. The Bank of Canada was the first major central bank to announce a reduction in its bond purchasing program from C\$4bn to C\$3bn a week. This was followed by the Bank of England, who reduced their weekly government bond purchases from £4.4bn to £3.4bn. The BOE bond purchase program of £150bn is expected to end by the end of 2021. Both the Fed and the ECB, however, have signalled no changes to the pace of balance sheet expansion. The Fed is currently purchasing \$80bn of treasuries a month with tapering not set to occur till the second half of 2022.

Furlough schemes distorting the labor market

The transitory argument is reasonable, given that sustained inflation has historically occurred only when most of the spare capacity in the economy has been eroded. At a glance, it appears that there is still plenty of room before supply constraints are hit. In the US, there are around 6 million fewer people employed than before the pandemic. Across Europe and the UK, millions remain furloughed. It is strange therefore that reports of labor shortages have emerged across the developed world. As services sectors begin to reopen, employers

are looking to hire at a record pace. However, labor supply has so far been unable to meet this surge in demand. Job openings in the US reached a record high of 8.1 million in May and yet nonfarm payrolls at the beginning of the month showed an increase of only 266,000 jobs, well short of the expected 978,000. In Germany, France and Italy, job vacancies are now above the pre-pandemic level. Economists and politicians have put forward a few reasons for why shortages are occurring. Firstly, the generous level of benefits in the US has likely disincentivised the unemployed to start looking for work again. In response, at least 24 states have planned to drop off the federal government supplemental benefits program which currently provides an extra \$300 a week to the unemployed. Similarly, in Europe furlough schemes may be holding back workers from severing ties with their current employer and changing jobs. The UK has seen an exodus of EU citizens and other international workers after the pandemic, which is exacerbating the shortage. If shortages are indeed a result of the pandemic fiscal support, then they should soon be resolved as these programs taper off towards the end of the year. However, it remains to be seen how many workers have permanently left the workforce as a result of the pandemic. A significant contraction in the labour force could create the conditions for upward wage pressure and ultimately sustained inflation.

Japan's recovery has stalled and is now falling behind the rest of the advanced economies. This is most evident in the latest PMI numbers for May. The composite PMI increased to 63.5 in the US, 62 in the UK, 58 in Australia, 60 in Canada and 57 in the EU, all indicating expansion in both manufacturing and services sectors. Japan however, saw a contraction from 50.1 to 48.1. This corresponds with the latest GDP figure for Q1 which showed negative growth of 1.3%. The main contributor to this decline has been private consumption in services which declined 2.6% over the last quarter, whilst the country was battling its fourth wave of infections. Japan is among a few Asian



countries (Malaysia, Thailand, Nepal) that posted highs in daily new cases in May. The current state of emergency, that was declared at the beginning of the year is set to end at the end of May. The outlook rests on the pace of vaccination. Japan only started vaccinating its elderly population at the beginning of this month and has now vaccinated 6% of its total population. Sadly, this has meant further uncertainty surrounding the 2021 Olympics. Many sponsors are now calling for the games to be cancelled, which would deal a further blow to the post-Covid recovery effort.

Better value outside the US?

Equity markets nudged higher despite the inflation-induced worries that saw equities sell off earlier in the month. Since the drastic sell-off a year ago equities have powered past pre-crisis levels. As a result, stock valuations are elevated, and many investors wonder if the rally will continue.

Given elevated valuation, expectations for further upside mainly resides in continued earnings growth. High household savings, robust fiscal stimulus, and optimism on economies fully reopening support the view that earnings will remain healthy in 2021 and 2022. However, much of this growth seems priced into US valuations, less so outside the US given the delay in rolling out vaccine programs.

More recently investor attention has been drawn to the Eurozone, encouraged by the emergence from a double-dip recession caused by the pandemic and as member states roll out coronavirus vaccines after a delayed start blamed on supply shortages and poor take-up by the public. The bullish outlook is based on the assumption that the Eurozone economy will begin rebounding at a more rapid clip in coming months as the recovery from the pandemic accelerates.

For now, taper worries have been placated as Fed officials have repeatedly insisted they will look through what they view as a transient jump in inflation to keep supporting the US recovery. Indeed, the fear of an interest rate shock occurring over 2021 has eased of late. The calming hand of central banks in bond markets has eased fears, helping the US 10-year benchmark end the month at 1.58%, 7bps lower from the previous month end. How long this period of tranquility lasts for remains to be seen. Most at risk from an interest rate shock remains overvalued equities, longer duration bonds and highly indebted economies.

Pyrford International

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