August 17th, 2020

Pockets of Inflation

- **Pockets of inflation causing some stress for investors.**
- **We do not expect a general rise in global inflation but remain watchful.**
- **Central banks in emerging markets still have scope for further rate cuts, although be patient with India.**
- **Good geopolitical news from the Middle East, if only there was more.**

Pockets of inflation are causing something of a pause in markets at present. While we don't believe there is a risk of a marked and sustained increase in inflation that would worry central bankers, it is a situation that investors must watch.

US inflation for July surprised to the upside with core inflation rising +0.6% month-on-month against expectations of +0.2%. Headline inflation is up to 1.0% year-on-year, and core inflation at 1.6%. Economists generally characterise the rise in inflation as a mixed picture with some components such as recreation and rents weakening.

We had mentioned before the strange gap between US 5-year government bond nominal yields that were previously around 0.21% and the 5-year break-even at 1.5%. Indexed-linked bonds were pricing a far higher level of future inflation than implied in conventional bonds. Break-evens remain around 1.5%, and the US 5-year government bond has seen yields has risen marginally up to 29.6bps.

US Households may be feeling the pinch from food price inflation. The food at home index has risen by more than 4% in the last four months, and overall food prices rose 4.6% year-on-year in July. The third highest since 2012. Interestingly in a New York Fed survey of household expectations for future inflation rose again last month to 2.9% for the one-year horizon and 2.7% for the three-year view.

July US retail sales grew 1.2% m/m well below forecasts (2.1%), however there were positive revisions to June's numbers (8.4% versus 7.5%) indicating a still-strong trend in spending growth - at least for the moment. In the detail of the report, all but one of the categories showed a gain in sales. The exception was building supplies and garden equipment.

However, there may be reasons for caution in extrapolating the current string trend in retail sales into the future. Several states have had to reimpose lockdowns, and Congress has still to implement a fiscal package to support households. The challenges are not lost on households - the University of Michigan survey of consumer sentiment in August while marginally ahead of expectations, the expectations of households, missed and are still quite pessimistic. As the statisticians stated, "overall confidence in economic policies fell to the lowest level since President Trump first entered office".

A good element of the recovery in consumer spending is already baked into many of the retail share prices. Although Amazon has driven a good deal of the gains, even adjusting for Amazon, the retail sector has made good progress.

The rise in the US bond yields has helped the US bank shares to recover. The share prices of the big banks were up 5-8% last week as the US 10-year yield moved towards 70bps, from 50bps a few weeks back. While the 10-year yield rose close to 90bps back in June, it finally reversed and sunk back to 50bps. Also, we doubt that the Fed will be too accommodating of a sharp increase in long term interest rates even if inflation expectations are on the rise.

India is another country struggling with a pickup in inflation. International investors will be concerned that the rise in inflation is overwhelming the efforts of the monetary authorities to support the economy through interest rate cuts. Foreign investment in the markets had only just turned to positive for the year after heavy outflows in March. Some of that foreign buying would have been on the premise of further rate cuts. However, with the Reserve Bank of India holding off from cutting rates at its last meeting and likely to leave rates unchanged potentially for the balance of the year foreign investor interest in the market may dry up.

While Indian inflation data is poor, the growth of industrial production gives us hope that inflation will abate. Indian inflation has spiked on the back of supply line challenges due to

COVID-19 continue. July inflation accelerated to 6.9% year on year compared to consensus forecasts of 6.3%. Core inflation, excluding gold, also strengthened to 4.8%. It's not all bad news though. Industrial production data shows that consumer non-durable output rose 115%. If that output growth is getting to market, one should hope that inflation could come tumbling down in coming months.

Mexico was able to cut rates last week by 50bps and look set to cut rates till further in coming months. Indeed the picture of rate cuts across emerging markets still seems largely intact encouraging us to stick with our positive view of emerging-market assets.

Easy monetary policy is particularly crucial for Asia. Recent policy notes from the Chinese central bank the PBOC highlights their commitment to supporting strong loan growth and the SME sector. The PBOC has in particular support official lending given the collapse of shadow bank sector lending.

It was good to see Mohamed El Erian emphasising the same issue that we have highlighted as **the achilles heel for the markets – the potential level of future bankruptcies.** In an interview with CNBC, he stressed that the more significant challenge for economic recovery is not the political spat between China and the United States but the worry of a major company going under, deflating the financial sector adding to unemployment and suppressing risk-taking in the financial sector. Every month that goes by, with global activity down significantly on a year ago, must be adding to the corporate stress.

We noticed that the Saudi Arabia sovereign wealth fund, **the Public Investment Fund had switched some investment from blue-chip stocks to ETFs in the second quarter.** Interestingly they sold BP, Boeing, Citigroup and Facebook and have reinvested in lower beta sectors via ETFs in sectors such as utilities, real estate and some cyclicality via the materials sector.

Staying with the Middle East theme, it was encouraging to see the renewal of diplomatic relations between Israel and the United Arab Emirates. Having worked in the Middle East, I always found that many of the Arab countries had a healthy level of respect for Israel even if the two sides were seemingly at odds. There are course many other elements the Middle East that still need to be brought into a friendlier and more constructive framework. If only broader peaceful solutions can be found, then the 400 million population could finally be put too good work with tremendous upside in terms of regional economic development and growth.

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