

THE BIG PICTURE OF GLOBAL ECONOMICS

GLOBAL CIO WEEKLY BY GARY DUGAN



July 20, 2022

US inflation hits 9% and everything is fine right?

- US inflation surprises to the upside but the markets take it in their stride
 - Fed looks minded to raise rates by 75bps or more
 - We suspect that while inflation will fall back it may persist for far longer than the markets will be comfortable with
 - China's growth disappoints but still has government support
 - ECB in focus this week with little room for error
-

You might also like our [As bad as it felt](#) and [The fed serves up a reality check](#). Click [here](#) to read them for free.

Last week's market movements only underscore the volatility and uncertainty that have come to characterise markets of late. Despite an **outrageously high US inflation data**, equities ended the week on a positive note, although 1-2% lower on the week. The US

10-year government bond yield fell 8 basis points, suggesting that the market believes the Fed is in control of inflation. Forgive us for not being so sanguine, but we still believe inflation is far from being under control.

Investors' tolerance for the Chinese authorities was on the wane as the equity market in the country unravelled some of its recent outperformance on weak economic data and ongoing trouble in the real estate sector.

This week brings a crucial ECB meeting against a backdrop of another political drama in Italy.

The spike in US consumer price inflation to 9.1% was a stark reminder of how persistently higher prices have undermined efforts to stabilise the economy. Further adding to the dour sentiments was producer price inflation, which at 11.3% was a reminder that businesses, too, continue to bear the brunt of higher prices. Nevertheless, economists tried to draw a positive from the bad news, basing much of that argument on the slide in core inflation and expectations that this data could prove to be the peak in US inflation. Indeed, core producer price inflation at 6.4% is down from the 7.1% reported in March.

Economists can also point to a list of commodities whose prices have fallen in recent weeks. Wheat is down 40% from its peak, corn prices have retreated 25%, and soybean is down 25%; in the energy market, WTI oil is 22% off its peak, while gasoline is down 30%.

Even if the current round of inflation data turns out to be the peak, the persistence of inflation will dictate the magnitude of interest rate increases going forward. Despite the arguments that inflation may have peaked finally, the financial markets moved to price in a more aggressive increase in policy rates at the next Fed meeting. The futures are now evenly split on whether the Fed will raise rates by 100bps or 75bps. As inflation continues to hold sway, the earlier expectations that the Fed would raise rates by just 50bps have dimmed significantly.

At mid-year, inflation in both US and Europe is averaging around 10%; however, economists still expect it to ease to approximately 7.5% in the third quarter. It's pertinent to note here that US inflation has hit 9%+ when the dollar has shown significant strength in mitigating imported inflation. Europe, on the other hand, is seeing a substantial boost in inflation from a 10% fall in the euro versus the dollar. Indeed, the impact of a weak euro and sterling may still only be working its way through the inflation numbers.

The persistence of inflation will therefore be heavily dependent on second-round effects. We would focus on the following two sources of second-round inflation effects:

Wage inflation: Until very recently, wage inflation trends had been relatively well behaved, but in truth, it was still too early to conclude that wage inflation pressures would not come back to pinch us. The sharp increase in the June Atlanta wage pressure in the US indicates that

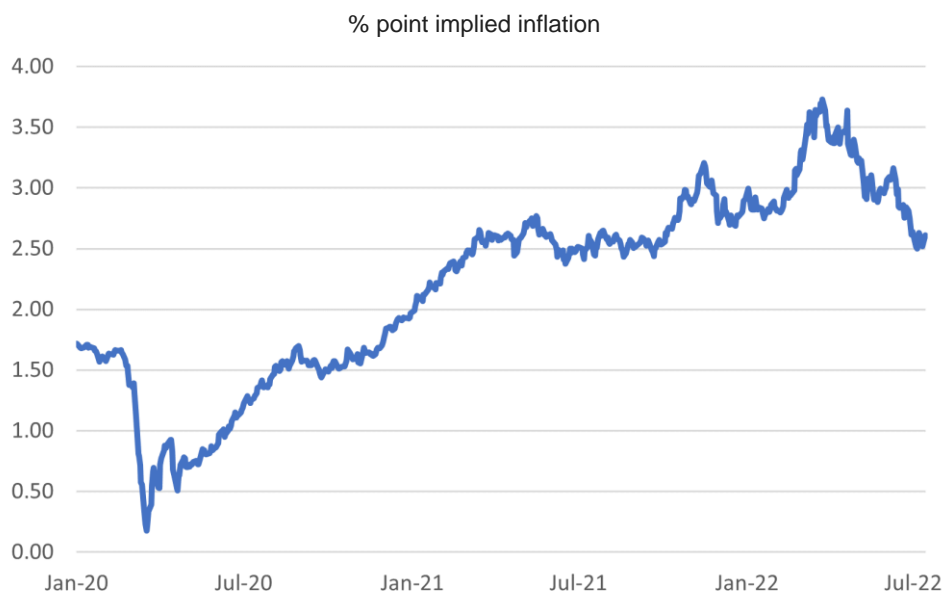
companies are seeing more labour cost pressures than the headline wage inflation data suggests. In Europe, the UK is witnessing a series of strikes, particularly in the transport sector, as unions press for wage increases north of 5%. IG Metall, Germany's biggest trade union, recently negotiated a 6% wage increase, the largest in 40 years.

Corporate inflation psychology: Over the last 20 years, corporates have typically had a zero-inflation mentality. The typical reaction of companies was to absorb cost increases rather than pass them on to customers and consumers. Cut to present and the companies are now forced to pass on the cost increases. Inflation pressures have quite frankly become too strong to absorb. Intel was a case in point last week as it announced prices increase of up to 20% due to "surging costs for production and materials".

We somehow struggle with the sanguine view taken by the US bond market that there is a smooth transition from lots of inflation to 'controlled inflation'. After a year of almost higher-than-expected inflation every month, economists still struggle to be ahead of the curve in (accurately) assessing just how high inflation can rise. The implied inflation baked into the inflation-linked market (TIPS) has drifted lower in recent months as the Fed has appeared inclined to bring inflation under control. US 2-year government bond yields still trade above 10-year bond yields, which also implies that the trouble is front-loaded and that all will be resolved in time.

We understand the arguments that the more inflation has surprised to the upside, the more the Federal Reserve has become hawkish. However, any sign that interest rates increases are failing to suppress inflation, the greater the risk of a further leg up in longer-term interest rates. For us, the jury is still out as to whether the Fed is truly in control of the inflation risks.

Chart 1: US 5 year break even inflation



Bloomberg

After a burst of good performance, Chinese equities suffered a setback last week as investors focused on weaker-than-expected GDP growth and fresh troubles in the property sector. While we are disappointed, we still believe that the authorities have the scope to provide props for growth and liquidity.

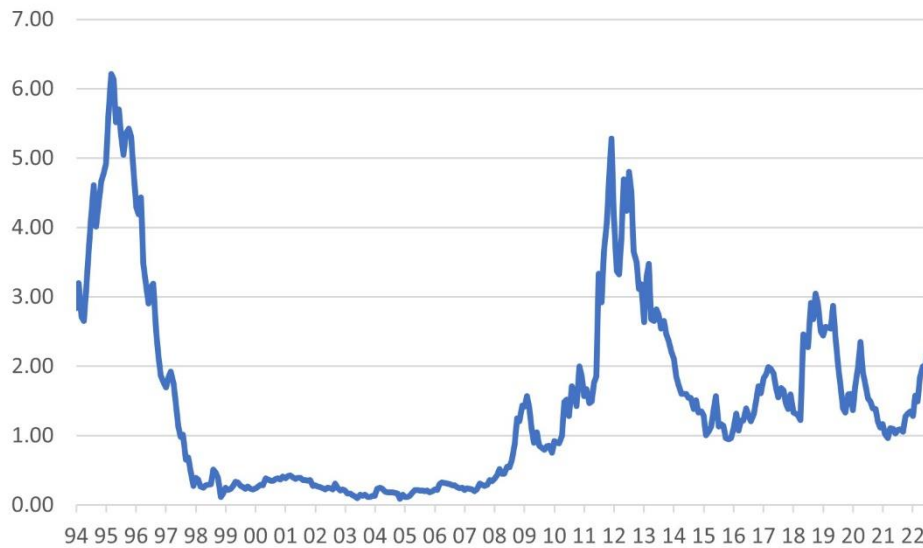
In China, the woes in the real estate sector continue to create investor angst. The China real estate developers' sector was down about 10% as media reports suggested that buyers were not servicing their mortgages. Country Garden, the blue-chip of the sector, saw its shares plunge 27% on the week, and its bonds traded mainly in the mid-30s. Worse-than-expected second-quarter GDP data did not help market sentiment either. Economists have reduced their full-year GDP forecast to around the 3.2% mark.

Despite the bad news, we maintain our constructive view of Chinese assets. Considering that times are tough in many parts of the world, asset prices can only rise where there is scope for constructive support from government spending and monetary authorities. For sure, the Chinese authorities are still displaying several missteps, but news last week of total social funding rising at a 10%+ rate can still provide comfort for investors.

This week in the eurozone carries significant risks of more volatility. We continue to characterise Europe as the major developed region most at risk of delivering a black swan event in the year ahead. Last week, the fall of the Italian government presages a crucial ECB meeting on Tuesday. The eurozone remains in fear of a marked widening of bond yields amongst member states. ECB Chief Ms Lagarde is to announce measures this coming week to try to keep bond spreads in check.

However, the fall of the Italian government and the marked widening of Italian bond yields over bunds only highlighted the challenges ahead. The ECB are on a tight rope trying to bring inflation under control through raising interest rates while trying not to wreck the status quo with any one state seeing a significant increase in borrowing costs. The ECB has got its work cut out to keep things under control. In the past week, the borrowing costs of the Italian and Spanish governments have widened by 20bps versus German bunds. The market is very nervous ahead of the ECB meeting. The euro looked at parity versus the US dollar before rebounding very modestly.

Chart 2: Italian 10 year debt spread over German bunds moves higher



Bloomberg

Gary Dugan
Johan Jooste
Bill O'Neill (Consultant)

Disclaimer & Important Notice

FOR THE INTENDED RECIPIENT'S USE ONLY

The Global CIO Office operates under Purple Asset Management. This document has been prepared by Purple Asset Management Limited ("PAM" or the "Company").

The document has been prepared on the basis of accounting and non-accounting grade information extracted from within the Company and its affiliates; and of publicly available economic and market data sources. This information has not been verified by an independent third party and should be treated accordingly. It is furnished to you solely for your information, should not be treated as giving investment advice and is to be kept confidential and may not be copied, reproduced, distributed, published, in whole or in part, or otherwise made available to any other person by any recipient.

The facts and information contained herein are as up to date as is reasonably possible and are subject to revision in the future. Neither PAM nor any of its directors, officers, employees or advisors nor any other person makes any representation or warranty, express or implied, as to the accuracy or completeness of the information contained in this document or undertakes any obligation to provide recipients with any additional information. Neither PAM nor any of its directors, officers, employees and advisors nor any other person shall have any liability whatsoever for losses howsoever arising, directly or indirectly, from any use of this document.

Whilst all reasonable care has been taken to ensure that the facts stated herein are accurate and that the opinions contained herein are fair and reasonable, this document is selective in nature and is intended to provide an introduction to, and overview of, the business of PAM. Any opinions expressed in this document are subject to change without notice and neither PAM nor any other person is under any obligation to update or keep current the information contained herein.

Such information contains "forward-looking statements" which are not historical facts and include expressions about management's confidence and strategies and management's expectations about future revenues, new and existing clients, business opportunities, economic and market conditions. These statements are made on the basis of current knowledge and assumptions. Various factors could cause actual future results, performance or events to differ materially from those described in these statements. These statements may not be regarded as a representation that anticipated events will occur or that expected objectives will be achieved. The forward-looking statements in this document are only valid until the date of this document and ISI does not undertake to update any forward-looking statement to reflect events or circumstances after the date hereof or to reflect the occurrence of unanticipated events. This document is not an offer to sell securities or the solicitation of an offer to buy securities, nor shall there be any offer or sale of securities in any jurisdiction in which such offer or sale would be unlawful prior to registration or qualification under the securities laws of such jurisdiction.