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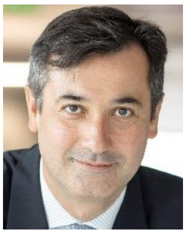
Research & Strategy Insights

Inflation anxiety

Monthly Investment Strategy Oped



Gilles Moëc,
AXA Chief Group Economist,
Head of AXA IM Research

Chris Iggo,
AXA IM Chief Investment Officer,
Core Investments

Key points

- While there is no "smoking gun" yet, the probability of a genuine self-sustained shift upward in the inflation trajectory is clearly rising in the US.
- Even if consumer prices will temporarily accelerate in Europe as well, the risk it morphs into a more permanent shift is lower there. The European Central Bank however will likely have to deal with more bond market contagion from the US.
- The inflation trajectory remains dependent on progress on the pandemic front. The latest data flow there reads as a mixed bag.
- Early cycle strength in commodities adds to inflation concerns
- Equities and short duration high yield returns usually positive when commodity prices are rising.

Reading through the noise

US inflation for April came out as a shock, with both headline and core indices surprising to the upside. What we had been bracing for is materializing: consumer prices are moving significantly higher but distinguishing the signal from the noise is going to be extremely difficult for several months (at least). Still, although there is no "smoking gun" yet which would make it certain that inflation is on the rise in a durable manner in the US, it is equally obvious to us that a rational analysis of available information would tilt the distribution of probability in that direction.

Let's start with the "noise". Much of the acceleration in core inflation could be traced to a few components standing for less than 5% of the index. Yes, bottlenecks are pushing prices up – and by a lot – in sectors such as motor vehicles, but these supply issues (e.g., the global shortage in microchips) do not reflect endogenous overheating (at least not yet). Inflation hawks are drawing attention to wage developments, possibly spurred by labour shortage. However, statistical noise there is also plentiful. Indeed, average hourly earnings rose by 0.7% on the month in April but compositional effects were mixed here, with a large rise in leisure and hospitality workers returning (331k), but also a higher share of non-supervisory workers, suggesting some bias to higher-paid employees as well.

Still, what should be a transitory shock can morph into something more sinister if expectations shift. That's why we should focus on survey-based measures of expected inflation. They can't tell us much about where inflation could be beyond six months, but at least they have been good predictors of short-term accelerations in consumer prices beyond the data noise. Their message is clear: inflation anxiety continues to rise. Five years inflation expectations have hit another peak in May in the Michigan University survey, to 3.1%, the highest level since 2011.

The majority of the Federal Open Market Committee (FOMC) around Jay Powell seem unified in their message of patience and they have strong points to make, in particular a possibility that the US goes through a soft patch once Biden's emergency stimulus fades, especially if the investment package currently under negotiation with the Republicans is smaller than expected.

But equally, by that time "genuine" wage hikes – i.e., beyond the mechanical effects of the reopening – may have started triggering proper cost-push inflation, while on the legislative side we continue to monitor projects such as the PRO Act (Protecting the Right to Organize), which would raise union power in the US private sector, and minimum wage proposals currently still held off at the Senate level. In the meantime, the Federal Reserve (Fed)'s dovishness and the Administration's largesse may fuel households' concerns over runaway inflation, contributing to further upgrades in expectations. While the Fed is unlikely to be swayed, they are going to be under a lot of pressure this summer as the price hump is likely to continue. Yields should go up in this environment.

Less advanced on the reopening and given the absence of a massive fiscal stimulus, the Euro area is much less at risk of "runaway" inflation even if base effects and bottlenecks will trigger a similar transitory acceleration in consumer prices. We should also remember that even before the pandemic struck, the European Central Bank (ECB) was not expecting inflation to hit its target by the end of its forecasting horizon. The starting point for any lift-off in the inflation trajectory is thus much lower in Europe than in the US. This supports those on the ECB Council now pushing for explicitly tolerating some overshooting in the future, which would help to re-anchor expected inflation back to the central bank's target. But that issue is unlikely to be addressed before the central bank completes its strategy review, September at the earliest. The immediate question to solve is how to mitigate any additional contagion from the US to the European bond market in the months ahead. The acceleration in the pace of the Pandemic Emergency Purchase Programme (PEPP) has not been conclusive so far. We note that at least one prominent sell-side house is now expecting the ECB to reduce its pace of buying at the June meeting. This would be risky in our view. It would run against the needed decoupling with the US and could push the euro higher.

We note that the debate on the inflation trajectory may become moot if the expected pace of post-pandemic reopening has to be revised down. Progress on vaccination continues in Europe, but we can't know for sure if we are not going to meet the same difficulties as in the US to cover the "last mile" as the resistance of anti-vaxxers starts to emerge. Against this background, flare-ups continue to appear here and there, forcing a resumption of restrictive measures. The Japanese government extended the state of emergency to three more Prefectures and tough social distancing has been re-imposed in Singapore. In the UK, the Prime Minister is preparing minds to the possibility his reopening schedule could be revised given the rising number of "Indian variant" cases in the North West of England. Global reopening is not going to be a straight line.

Supply frictions pushing commodity prices higher

What is happening in commodity markets is contributing to the anxiety around inflation. Prices of numerous commodities – energy, industrial metals and agricultural – have risen sharply this year. This has pushed up manufacturing input prices as noted in higher producer prices and in the prices components of purchasing manager surveys. Moreover, several companies referred to higher input costs in the first quarter (Q1) earnings reports. At this stage the evidence suggests that these higher prices are being absorbed but it is a trend that investors and policy makers need to watch closely.

There are some general points to make here. Rising commodity prices are consistent with economic recoveries, particularly after an abrupt downturn in activity, the like of which we saw last year. More than in normal cycles, demand has been able to recover quickly over recent months while the supply-side of the global economy has been more constrained. The typical business cycle sees commodity price inflation begin to ease as supply responds to higher levels of demand, but those early cycle price pressures can feed through. Supply pressure can also be seen along the value chain. Shipping freight rates, for example, have risen sharply in response to container capacity having been mothballed at times last year and being in the wrong place to meet increased trade volumes.

Generally, total returns from equities and excess returns from credit in the bond market are positively correlated with rising commodity prices. This relationship stems from rapidly improving final demand supporting earnings and the capacity of companies to swallow higher costs in the early stages of the cycle. If there appears to be spare capacity in labour markets, equity investors should not be too concerned about margin erosion. However, in some sectors, it is not just materials prices but shortages that are becoming an issue for companies. Semi-conductor shortages are widespread, hitting numerous sectors including autos as well as the broader technology sector. In the US, the booming construction sector is facing shortages (and higher prices) of basic inputs, such as lumber. The technology sector's performance since Q1 earnings reports has been disappointing, reflecting investor concerns that hardware production will be disrupted, hitting sales.

In addition to cyclical pressures, increased investment in the green economy is underpinning strong demand for metals such as copper, cobalt, and lithium. This serves to remind us that the shift to renewable energy production does not mean the end of depleting natural resources, something for Environmental, social, corporate governance (ESG) focussed investors to consider. Generally, commodity producing countries have seen strong equity market and currency performance and these trends could persist as the global economy continues to emerge.

Higher inflation is evident across the supply chain as economies re-open. But we are in the early stages and the argument as to whether these are genuine medium-term inflation signals will not be settled for some time. For now, the assets that should display better relative performance are cyclically biased equities, high-yield bonds and short-duration fixed income assets. We continue to have few concerns about credit markets – other than the fact that spreads are extremely tight. The main danger for all markets, given current valuations, is that the more warning lights flash about inflation, the greater the risk that the resolve of central banks to see through the current rise in prices starts to weaken. By setting out a policy roadmap mixing macro-economic targets with a form of time dependency, the Fed (and others) risks losing credibility at some point if the blip in inflation does feed into higher expectations and a more persistent increase in price levels. Given that US Treasury 10-year yields hit 1.78% a few weeks ago, there remains plenty of scope for bond markets to price in such a scenario. Another bout of yield curve steepening and bringing forward of Fed rate hike pricing seems highly likely in the months ahead. As such, short duration is likely to remain a driving theme for many investors in both bond and equity markets.

Download the full slide deck of our May Investment Strategy

Recommended asset allocation

Asset Allocation	Negative	Neutral	Positive
Key asset classes			
Equities			■
Bonds	■		
Commodities		■	
Cash		■ ▲	
Equities			
Developed			
Euro area			■
UK			■
Switzerland		■	
US			■
Japan		■	
Emerging & Sectors			
Emerging Markets		■	
Europe Cyclical/Value			■
Euro Opening basket			■
Euro Financials			■
US Cyclical/value		■	
US Financials			■
Global semiconductors		■	
Fixed Income			
Govies			
Euro core		■	
Euro periph		■	
UK		■	
US	■		
Inflation			
US		■	
Euro		■	
Credit			
Euro IG		■	
US IG		■	
Euro HY		■	
US HY		■	
EM Debt			
EM bonds		■	

Legends: Negative | Neutral | Positive — Last change: ▲ Upgrade | ▼ Downgrade

Source: AXA IM Research – As of 21 May 2021

Macro forecast summary

Real GDP growth (%)	2020	2021*		2022*	
		AXA IM	*Consensus*	AXA IM	*Consensus*
World	**-3.7**	**5.6**		**4.3**	
Advanced economies	**-5.3**	**5.3**		**4.1**	
US	**-3.4**	**6.9**	5.7	**4.5**	4.0
Euro area	**-6.8**	**3.8**	4.3	**3.6**	4.2
Germany	**-5.3**	**2.4**	3.4	**3.3**	3.8
France	**-8.3**	**6.0**	5.5	**3.6**	3.7
Italy	**-8.9**	**4.5**	4.2	**4.1**	4.0
Spain	**-11.0**	**4.5**	5.7	**4.7**	5.7
Japan	**-4.9**	**2.7**	2.8	**2.9**	2.3
UK	**-10.0**	**6.4**	4.6	**5.9**	5.8
Switzerland	**-3.0**	**3.4**	3.2	**2.9**	2.9
Emerging economies	**-2.7**	**5.7**		**4.5**	
Asia	**-1.5**	**7.4**		**5.1**	
China	**2.3**	**8.5**	8.4	**5.5**	5.4
South Korea	**-1.0**	**3.5**	3.5	**3.0**	3.1
Rest of EM Asia	**-6.0**	**6.5**		**4.7**	
LatAm	**-7.3**	**4.0**		**2.8**	
Brazil	**-4.1**	**3.0**	3.3	**2.3**	2.4
Mexico	**-8.5**	**4.7**	4.4	**2.5**	3.0
EM Europe	**-2.3**	**3.1**		**3.6**	
Russia	**-2.8**	**1.8**	2.9	**2.5**	2.6
Poland	**-2.7**	**3.3**	4.1	**4.6**	4.7
Turkey	**1.6**	**4.5**	5.1	**4.6**	3.9
Other EMs	**-3.7**	**3.3**		**4.1**	

Source: Datastream, IMF and AXA IM Macro Research – As of 21 May 2021

* Forecast

CPI Inflation (%)	2020	2021*		2022*	
		AXA IM	*Consensus*	AXA IM	*Consensus*
Advanced economies	**0.8**	**2.1**		**1.5**	
US	**1.2**	**3.1**	2.4	**2.4**	2.2
Euro area	**0.3**	**1.5**	1.5	**1.1**	1.3
Japan	**0.0**	**0.0**	-0.1	**0.4**	0.5
UK	**0.9**	**2.0**	1.6	**2.1**	2.0
Switzerland	**-0.7**	**0.1**	0.3	**0.4**	0.5

Source: Datastream, IMF and AXA IM Macro Research – As of 21 May 2021

* Forecast

These projections are not necessarily reliable indicators of future results

Forecast summary

Central bank policy Meeting dates and expected changes (Rates in bp / QE in bn)		Current	Q1 -21	Q2-21	Q3-21	Q4-21
United States - Fed	Dates	0-0.25	26-27 Jan 16-17 Mar	27-28 Apr 15-16 Jun	27-28 Jul 21-22 Sep	2-3 Nov 14-15 Dec
	Rates		unch (0-0.25)	unch (0-0.25)	unch (0-0.25)	unch (0-0.25)
Euro area - ECB	Dates	-0.50	21 Jan 11 Mar	22 Apr 10 Jun	22 Jul 9 Sep	28 Oct 16 Dec
	Rates		unch (-0.50)	unch (-0.50)	unch (-0.50)	unch (-0.50)
Japan - BoJ	Dates	-0.10	20-21 Jan 18-19 Mar	26-27 Apr 17-18 Jun	15-16 Jul 21-22 Sep	27-28 Nov 16-17 Dec
	Rates		unch (-0.10)	unch (-0.10)	unch (-0.10)	unch (-0.10)
UK - BoE	Dates	0.10	4 Feb 18 Mar	6 May 24 June	5 Aug 23 Sep	4 Nov 16 Dec
	Rates		unch (0.10)	unch (0.10)	unch (0.10)	unch (0.10)

Source: AXA IM Macro Research - As of 21 May 2021

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Our Research is available online: http://www.axa-im.com/en/insights

AXA Investment Managers SA
Tour Majunga – La Défense 9 – 6 place de la Pyramide 92800 Puteaux – France
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