Weekly Market Summary

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Will Elevated Inflation Prove Transitory or Temporary?? Depends on Who You Ask!!

Fadi Nasser - Deputy Chief Investment & Treasury Officer

Central bankers continue dismissing market inflation concerns, insisting the world's most powerful governments / central banks will go full speed with their efforts to reduce slack in the world economy and revert back rapidly to full employment. Above-target underlying rates of inflation in the US and Europe (latest year-on-year CPI figures stand at 5.4% and 3.0% respectively!), coupled with multi-asset bubble formations, have had so far little effect on their seemingly blasé attitude towards an overheating economy and surging price pressures. The view promoted by these global central banks is that (1) the supply bottlenecks and labour market shortages will be temporary and (2) wage indexation and labour force unionisation are not as dominant. As a result, the Phillips curve (which states that inflation and unemployment have a stable and inverse relationship) seems to matter less and inflation expectations should remain well anchored. That in turn implies (in their opinion) that the spike in inflation will prove transitory while the global economic recovery is set to continue, albeit at a slower pace compared to the first half stunning performance.

In that context, investors learned this week that the U.S. economic growth "*downshifted*" slightly to a moderate pace in early July through August. "The deceleration in economic activity was largely attributable to a pullback in dining out, travel, and tourism in most Districts," the U.S. central bank said in its Beige Book survey released on Wednesday. The information was based on anecdotal information collected by the Fed's 12 regional banks through August 30th and compiled by the Federal Reserve Bank of New York. A majority of regional Feds said that the spread of the delta variant had led to the pullback in economic activity in their districts. The Beige Book also noted that "*inflation was reported to be steady at an elevated pace... Looking forward, contacts anticipate facing cost increases and charging higher prices in coming months*," the survey said (surely that doesn't sound like transitory inflation?!)

Yesterday, the European Central Bank (ECB) left rates unchanged though it decided to slow the pace of its pandemic bond-buying program in the final quarter of 2021, a shift President Christine Lagarde insisted is not a move heralding a wind-down in stimulus for the euro-region's still-vulnerable recovery. "*The lady isn't tapering*," she told reporters in Frankfurt, describing the ECB's decision on Thursday as "*a recalibration of the pandemic emergency purchase program for the next three months*." Lagarde spoke after the Governing Council decided it will conduct purchases at a "*moderately lower pace*" than the roughly 80 billion euros ($95 billion) of monthly acquisitions deployed in the past two quarters. She justified the decision by saying the euro region's "*increasingly advanced*" rebound could be maintained with less monetary help. Whilst Lagarde said the decision was unanimous, keeping that consensus will surely be a challenge among policy makers whose judgments on the threat posed by inflation are known to differ (the list includes Germany's Jens Weidmann, Austria's Robert Holzmann and Netherlands' Klaas Knot, who lately sounded the alarm on the risks associated with disregarding higher European inflation and maintaining an ultra-accommodative monetary stance for too long). The ECB president also cautioned that the global spread of the delta variant could yet delay the full reopening of the economy and reiterated that the quickening growth in consumer prices is expected to be "*temporary*" (not to be mixed with "*transitory*", a US Fed trademark 😊) - sharing new forecasts that put inflation below the institution's 2.0% target in both 2022 and 2023!

For all central bankers' soothing words, we remain unconvinced and continue to worry that a more persistent inflation overshoot in the coming months will force central banks around the world to reconsider their ultra-dovish policy stance, despite recent evidence that the global recovery peaked in Q2 and appears to be slowing down. In recent weeks, many strategists have come to the same view and started suggesting that a bout of elevated inflation might not be quite as transient as the Federal Reserve and European Central Bank expect. At some point in the near future, sustained price pressures could upset investors by challenging the benign outlook that envisages a very gradual reduction in pandemic-era Fed/ECB stimulus. For now, market-derived gauges of inflation expectations still seem to suggest faith in the central banks' ability to hit something close to the 2.0% average inflation goal. However, "*if these inflation measures persist, even if the Fed doesn't move up their calendar, if the market believes it will, it becomes a self-fulfilling prophecy*," said Anna Han, Wells Fargo Securities equity strategist. "*You start seeing investors take positions in a certain way to help move those markets. We are concerned about it.*" At the same time, Han noted that "*if you are beginning tapering it's a sign that things are good, that those price pressures are being passed along to the consumer and, right now, with demand being strong, I think it would go over rather smoothly*."

Others seem to disagree. Weakening growth and a renewed spread of the coronavirus' delta variant will hold the US Federal Reserve back on its plan to taper debt buying anytime soon. Even 2023 may be too early for the Federal Reserve to begin raising interest rates, according to noted bond bull Steven Major. "*I'll believe it when I see it*," the HSBC Holdings Plc global head of fixed income research said in his latest Bloomberg TV interview. "*It's unlikely the Fed is going to hike any time soon. In fact, I would even argue that 2023 is too soon.*" Major's views come as market watchers wrestle with the Fed's intentions after a disappointing August U.S. jobs report which may have delayed plans for a move to first scale back asset purchases at its upcoming September 22nd FOMC meeting. Major also maintained his longstanding bullish expectations for bonds, targeting a 10-year Treasury yield closer to 1.0% by the end of this year, from 1.32% this morning. "*I don't fully understand why consensus forecasts are anywhere near 2.0%*" with the Fed needing to make a very rapid and unlikely tilt for that to happen, he stressed (I'll tell you why when it happens Steven 😊! Something along the lines of investors' lost faith in central banks' credibility and extra capability!)

In other major news this week, China made an unprecedented intervention in the global oil market, releasing crude from its strategic reserve for the first time with the explicit aim of lowering prices. The announcement comes amid surging energy costs in China, not just for oil but also for coal and natural gas, and electricity shortages in some provinces that have forced some factories to cut production. Inflation is rapidly rising too, a political headache for Beijing. In a late statement on Thursday, the National Food and Strategic Reserves Administration said the country had tapped its giant oil reserves "*to ease the pressure of rising raw material prices.*" The Chinese stockpiling agency also said a "*normalized*" rotation of crude oil in the state reserves is "*an important way for the reserves to play its role in balancing the market*", a hint that it may continue to release barrels. The agency said that putting national reserve crude oil on the market through open auctions "*will better stabilize domestic market supply and demand.*" China, the world's largest oil importer, has built up a 220 million barrels reserve of the commodity over the past decade, according to Energy Aspects Ltd. The buffer differs from strategic petroleum reserves, known as SPR, held in the U.S. and Europe, which are usually only tapped during supply outages and wars. Brent crude futures retreated as much as 2.5% on the news yesterday but have since managed to recoup all losses this morning (last at $72.75 a barrel). Elsewhere, bitcoin too had a rough week (slumping more than 10% on Tuesday) despite becoming legal tender in a sovereign nation (El Salvador) for the first time since it was introduced. However, technical glitches around the rollout and demonstrations against crypto adoption spoiled the debut and sent other digital currencies lower in sympathy. Bitcoin was last trading at $46,210, after spending much of the week oscillating between $43,050 and $52,921.

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