Weekly Market Summary

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It's Here! The Most Expensive Thanksgiving Meal and Uncomfortable Inflation!

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Last week, we saw some big moves in the markets following policy decisions from a few major central banks, the OPEC+ meeting, and a handful of key economic data. As this week closes out and we take a look back, the most notable development was the shocking US CPI print on Wednesday.

Nothing went right for team transitory or the Federal Reserve in October's CPI release. US consumer prices jumped in October at the fastest pace in three decades as inflationary pressures spread further throughout the economy, putting the Biden administration on the defensive and increasing prospects that the Federal Reserve will raise interest rates next year. The Consumer Price Index published by the Bureau of Labor Statistics on Wednesday rose 6.2 per cent in October from a year ago — the fastest annual pace since 1990 and a sharp increase from September's levels of 5.4 per cent. The increase was broad-based. Higher energy prices, intensification of supply-chain bottlenecks and higher rents all pushed up prices briskly in the consumer basket.

Meanwhile, the Fed refuses to take any responsibility for inflationary pressure. There is no acknowledgment that trillions in money printing might be contributing to rising prices. In the 20 months since March 2020, the Fed has increased the assets on its balance sheet by $4.2 trillion. It's nearly doubled its total assets to $8.6 trillion. The US government unleashed over $5 trillion in deficit spending. That totals nearly $10 trillion in stimulus. It was, by definition, trillions in inflation.

This is certainly not something the Biden Administration wants to be seeing. US President Joe Biden on Wednesday singled out rising energy costs as a primary driver of inflation and said it was a "top priority" to reverse the continuing trend. "I have directed my National Economic Council to pursue means to try to further reduce these costs and have asked the Federal Trade Commission to strike back at any market manipulation or price gouging" in the energy sector, he said in a statement. His other go-to prescription to inflation is passing the $1.85 trillion collection of spending programs and tax cuts that is currently languishing in the Senate. His argument is that in the long run, the bill and his infrastructure plan could make businesses and their workers more productive, which would help to ease inflation as more goods and services are produced across the economy. On the other hand, many researchers, including a forecasting firm that Mr. Biden often cites to support the economic benefits of his proposals, say the bill is structured in a way that could add to inflation next year, before prices have had time to cool off.

Where inflation is heading will depend on a number of factors. Forecasting inflation has been incredibly challenging over the past year and will remain tough. However, majority of expectations are for headline inflation to top 6.8% year on year in November. The main factors would be persistent price gains for energy and shelter and adverse base effects. This forecast is also conditioned on other categories posting a similar pace of inflation – meaning reopening sectors do not experience steep hikes during the holiday season. Covid disruptions, port congestion, and semiconductor shortages will keep upward pressure on manufactured goods this holiday season. Falling real wages and shrinking profit margins will continue to depress output, and the US economy entering a period of stagflation something like the late 1970s is finding its place higher on the cards.

When it comes to monetary policy, the US central bank has been exceptionally good at communicating its intentions lately. As a result, we seem to be tapering without a taper tantrum. This is good, and a welcome contrast with the BoE. But the Fed's policy framework is a bit of a mess. Its average inflation targeting framework is vague. They can't even agree on what an average is. This might cause trouble before long, dots or no dots. The broadening of inflation across categories opens up the possibility that the Federal Reserve could quicken the pace of taper in order to create the optionality for an earlier rate lift off in 2Q 2022 (market is now pricing almost three hikes by 2022 YE). Even after six straight months of annual CPI increases over 5%, Jerome Powell continues to insist inflation is "transitory" and the result of a "supply chain problem". That said, the bar for a change in course and abandoning the patient view on rates is extremely high and would require significant upside surprises in inflation in November and December.

US government bonds sold off sharply on Wednesday. Yields on two-year Treasury notes, which are highly sensitive to interest rate expectations, rose by the most since the market turbulence triggered by the coronavirus outbreak in March 2020. The yield increased 0.09 percentage points to 0.52 per cent, signalling a significant fall in price. The biggest move was in the five-year note, which rose 0.14 percentage points to 1.22 per cent. Gold wore a space suit and jumped by some $30 after initially spiking lower to hit its best levels since June. The dollar touched its strongest point against the euro in 16 months on Thursday. For FX traders, it is about which central bank is more hawkish relative to another. The market knows that the Fed always tends to be behind the curve anyway. The central bank's recent changes in how it targets inflation and its loose definition of "transitory" means that, despite the latest upsurge in inflation, it wouldn't want to get too hawkish relative to other major central banks, especially the European Central Bank as that would undesirably weaken the EUR/USD exchange rate. That being said, the dollar will likely remain in buy-the-dip mode, especially against weaker currencies like the EUR, as well as CHF and JPY, where the central banks are deemed to be less hawkish or more dovish than the Fed.

What is more concerning is that fact that Mr. Transitory is not only residing in the US nowadays. Inflationary pressures rippled through China and Europe as data showed this week. China's Consumer Price Index rose 1.5% in October from a year ago, double the rate of the previous month and the fastest pace of increase since September 2020. October marks the first-time consumer inflation has picked up in five months. The rate had been gradually diminishing since May. But rising energy bills and food supply chain disruptions have begun to stoke higher prices. Many economists said they expect China's industrial inflation will edge lower in the coming months as Beijing's interventions cut coal prices more over time. In addition, they say consumer demand in the West for Chinese goods is likely to pull back further. In Europe, European Union finance ministers agreed on Monday that the current surge in consumer prices would subside next year, and that high public debt created by the pandemic had to be reduced, but in a way that would not hurt economic growth. While boosting the outlook for prices in 2021 and 2022, the European Union's executives see inflation averaging just 1.4% the following year – below the European Central Bank's 2% target.

To conclude, it's not often that you can celebrate economic history, but Wednesday was one of those days; If you were born after 1990, you are currently experiencing the highest annual inflation rate of your life. Congrats!

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