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MARKET INSIGHTS

The latest Market Insights
from the Connected Wealth team

Inflation Sprouts

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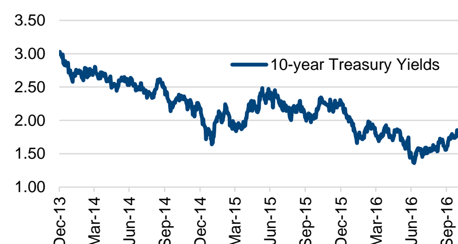
The secular inflation cycle peaked in the early 1980s and, apart from a few brief counter cyclical periods, has been falling ever since. Which does raise the question whether the recent sprouts of inflation are going to grow or wither. The new president in the U.S. is certainly contributing to the market reaction in the bond market, due to his potential inflationary policies, yet this move in yields and inflation data started long before the election. Fiscal policy, higher commodity prices, a tightening labour market, these may be enough to help fertilize the current sprouts of inflation. If so the deflationary trade that has been so lucrative for so long may be nearing its end.

The bond market appears convinced inflation is on the rise. The top chart is the 10-year U.S. Treasury yield over the past few years and they started rising shortly after the dip from the Brexit vote. More impactful, inflation swaps as measured by the spread between real and nominal bonds (2nd chart) have been pricing in steadily higher inflation.

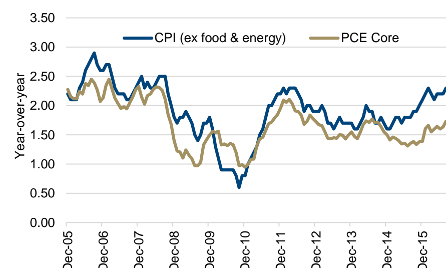
Most agree, moderation is key for just about everything in life such as eating, exercise, drinking. The same goes for inflation, it is actually healthy for prices to increase in a stable manner. A primary goal for both Mr. Polloz and his American counterpart Janet Yellen is to target 2% inflation on an annual basis. Since 2008, this target has proven largely elusive. Yet over the past year inflation trends appear to have firmed (3rd chart).

Bond Yields started rising after Brexit, then accelerated after the election

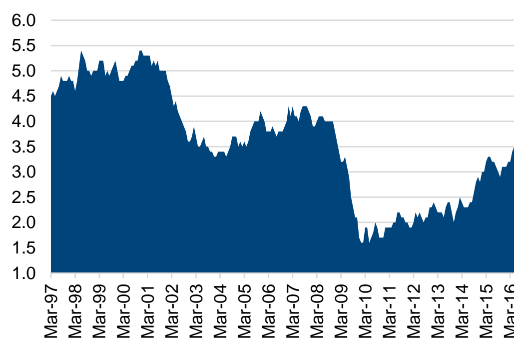


5yr/5yr Inflation Swaps appear to be on the rise

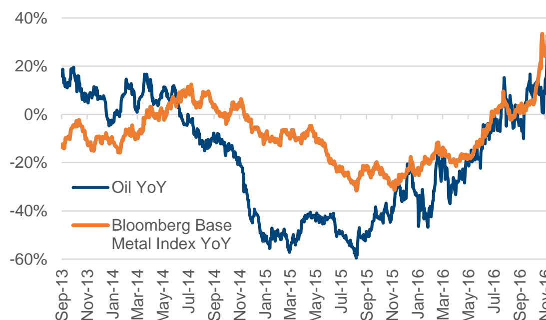
Key Headline Inflation Measurements
Not inflationary, but certainly trending higher



Nobody likes paying more for the same thing than they did in the past, but at the end of the year if your income increases by a greater percentage than your purchases, it is not necessarily negative. And wages are rising. The Atlanta FED wage growth tracker has risen to 3.9% recently (top chart), outpacing the broad base Consumer Price Index which most recently registered 1.6%, in America, on a year over year basis. There is contradicting research as to whether wages drive inflation or inflation drives higher wages. Based on intensive research by Goldman Sachs it appears that in this cycle higher wages are leading inflation higher. The labour market continues to tighten as the U.S. economy has been consistently adding about 200k jobs a month for the past five years. And the unemployment rate in the U.S. being under 5% is below the Non-Acceleration Inflation Rate Unemployment (NAIRU), which by definition supports continued inflation pressure.



Recent inflationary pressures have also come from commodity prices. After two years of eliciting deflationary pressure, oil and base metal prices are now running higher on a year-over-year basis. Some of the basic building blocks such as steel, are up over 100% this year. As these are inputs into the value chain, there is certainly a knock-on effect for prices.



High costs from commodity prices, transportation costs and wages all flow into the cost of goods, some of which is absorbed at the company level, some are borne by end consumer. It may be of rising importance going forward to understand which companies are mostly likely to see the biggest rise in costs as well as which companies are best suited to pass those increases to consumers. Sectors that have the largest percentage of cost of goods sold as a percentage of revenue are food retailers, utilities, home builders, aerospace and any pure play commodity company, like a steel manufacturer as an example. Companies that have the easiest time passing rising costs through to the customer are companies in the consumer staple and luxury goods sector. If the cost of tobacco leaves increases cigarette, companies can just raise the cost of a pack of smokes knowing their customers are loyal to the habit. Or, if some Ferragamo loafers are $869 this year but were only $849 last year, snobby shoe buyers are not going to shy away and miss out on being a part of the newest trend. On the other end of the spectrum, transportation and general retail have a hard time flowing costs to customers because there are an abundance of alternatives and competition.

These are just inflation sprouts at the moment, which could wither should we see a drop in economic activity (economic frost). Yet there are mounting pressures that argue for at least somewhat higher levels of inflation and bond yields. More importantly, after so many years of declining yields, how sensitive are many portfolios should yields continue to rise? Good time to check your interest rate sensitivity.

Charts are sourced to Bloomberg unless otherwise noted.

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