
A MOMENT IN MARKETS – MAKING SENSE OF THE RAGING INFLATION PRINTS

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17 Sep 2021

A sigh of relief? Hardly.

The combination of frequent data releases and human fallibility creates a problem. People are inclined to process information relative to anchors. Recency bias dictates that these anchors shift quickly to the latest available data point. Thus, each data release is compared to the previous one resulting in a myopic perspective. What we often need is to zoom out and look at the bigger picture.

Does an annual inflation reading of 5.3% in August suggest that rising prices are no longer a concern in the US? It does if one's anchor is July's reading of 5.4%. But if inflation remains in the range of 4-6% for another few months, and above 2.5% for, say, over 12 months, that is high enough and long enough to warrant investor attention.

Dissecting the 5.4% figure reveals three key dimensions of inflation. Energy, food, and new vehicles were among the sectors driving higher prices suggesting that base effects, supply chain challenges, and pent-up demand are among the forces potentially at play. Adding to the array of inflationary factors is a tightening labour market and expectations of further fiscal accommodation. It isn't unreasonable, therefore, to postulate that base effects alone aren't driving higher prices.

So, what might the Federal Reserve (Fed) do when it meets on 21-22 September? Given its focus on maximum employment, it is unlikely the latest inflation figure will break the central bank's 'inflation is transitory' narrative. An increased sense of urgency in raising interest rates, perhaps as early as next year, is therefore difficult to envision. Better guidance on tapering its bond purchases, starting possibly this year, can possibly be expected though.

Across the pond, the UK has recorded its highest level of inflation in 9 years. With restaurants fully booked, public transport packed, and people beginning to fly overseas on holidays, it is no surprise that UK's 3.2% consumer price index (CPI) inflation figure for August has been driven by food, transportation, and hospitality sectors. Eurozone inflation has climbed to 3.0% in August, its highest reading in nearly a decade. And although energy and food were the major culprits looking at the headline figure, core inflation – which excludes those two sectors – has also risen to its highest level since 2012.

While the European Central Bank (ECB) remains in 'wait and watch' mode, the Bank of England (BOE), unlike the Fed, has expressed a desire to reduce the size of its balance

sheet. Nevertheless, the actions of the Fed are likely to provide a blueprint for BOE and ECB alike, given the US remains meaningfully ahead of both the UK and Europe on the inflationary cycle.

Persistently dovish monetary policy in the wake of continuously rising levels of inflation, therefore, warrants attention from investors. Traditional inflation hedges such as broad commodity baskets are among the tools investors can consider. Targeted baskets, such as industrial metals, may also prove effective given their correlation with inflationary factors including supply chain challenges and fiscal stimulus in the form of infrastructure spend.

It is also worth considering how resilience can be added to equity portfolios at a time when inflation and monetary policy can create uncertainty. One approach is to combine cyclical and long-term growth factors with an all-weather factor like quality to offer balance through diversification.

There are no right answers in investing. The best one can hope for is to hold a reasonable mix of assets considering the risks and opportunities. Inflation is likely to remain topical, and actions of central banks are not just going to attract eyeballs, but influence market moves.

Sources

Bloomberg and Trading Economics as of 17 September 2021.

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