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weekly

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No Mr Bond(s), I expect you to fall

by Michael Clough, CFA

I recently went to see the latest James Bond film to watch Daniel Craig's last appearance as the British superspy. It was Craig's fifth outing since his introduction in 2006 and the latest release marked a rather explosive end of an era in the latest storyline of 007. In our slightly less glamorous world of investment management, might we be facing an end of an era moment too? Since 2010 inflation in G10 countries has averaged 1.5%, below the typical 2% central bank target. This year we have seen inflation move sharply higher and whilst much of the narrative has suggested these moves are transient in nature, events in the past few weeks have posed a valiant challenge to this view.

Firstly, the transient case. The sharp increases are the consequence of three forces: base rate effects with year-on-year prices higher this year given last year's economic collapse, a sharp resumption of activity as lockdown restrictions have eased (demand-pull inflation) and supply shortages in a range of industries squeezing the availability of goods (cost-push inflation). These have helped producer and consumer price inflation to hit 11.8% and 5.4% in the US this year, levels we haven't seen since 1980 in the case of producer prices. For Bond fans that's back to Roger Moore times but it's a move which his predecessor Sean Connery might call 'shocking, positively shocking'. Central bankers were largely aligned to the transitory view – the increases being the result of pandemic-related disruptions and before long deflationary forces, such as technological disruption, demographics and debt would take charge again and inflation would retreat, meaning no sharp tightening of monetary policy would be necessary.

However, the recent explosion in wholesale gas prices (up 400% this year at one point in Europe) resulting in higher household energy prices, along with higher oil, petrol and food prices will work their way into inflation numbers and could persist for some time. These effects have evidently fuelled the argument that inflation might indeed be less transient and they have forced Bank of England governor Bailey to announce that the central bank 'will have to act', referring here to raising interest rates.

Then you have the structural inflation case, which centres on the monetary stimulus since the onset of the Covid pandemic. Year-on-year (M2) money supply growth rose to just under 25% late last year, the highest ever observed, and remains elevated today. The underlying thesis is if there is suddenly more money chasing the same number of goods, or if money supply exceeds what is needed to finance economic growth, then prices must rise and they will remain high until money supply is brought under control. Critics will point to stubborn sub-target inflation after the post-GFC stimulus programs – partly explained by banks retaining a lot of the money created and thus less worked its way into the real economy – though monetary injections over the past 18 months have been far greater than back then. Wage inflation will also likely be key here. So far it hasn't followed recent input or consumer prices much higher but should it do so, conceivable given widely reported labour shortages, it will further strengthen the case for more entrenched inflation.

So, what do markets think? US expectations have remained reasonably well anchored - expected inflation for five years starting in five years' time (5y5y inflation) has moved to 2.6% per annum, above 2% but only 0.1% higher than the average of these expectations since 2010. The moves have arguably been more noteworthy in the UK and Europe, with 5y5y expectations in the former at their highest in the post-crisis era (4%) and in the latter they have just hit 2% for the first time since 2014. Generally, expectations have risen but runaway inflation is not anticipated. We certainly feel the risks of more persistent inflation have increased recently but on balance continue to believe a normalisation of the shorter-term dislocations should help to keep it in check.

As we wait to see who hits the screens as the next 007 we will have to wait and see what inflation numbers hit our Bloomberg screens in the months ahead. Nevertheless, as multi asset investors we want to construct portfolios that can deliver in a range of scenarios, in other words own assets that can shield and shine during episodes of higher inflation. Over the last year a general bias towards inflation linked bonds, largely US TIPS, over nominal government bonds has been supportive but even after recent yield increases they look expensive and we hold principally for portfolio ballast. Inflation linkage embedded within property and infrastructure assets is our preferred route, along with value equities and floating rate bonds.

Source: All market data sourced from Bloomberg Finance, L.P.

Market Focus

- **Global equities returned +1.4% last week**
- **Measures of expected inflation showed a continuation of recent trends and increased over the week**
- **Brent Crude rose +0.8% last week to $85.5 a barrel**
- **Gold rose +1.4% last week to $1792.6 per ounce**

US

- US equities returned +1.7% last week with all major indices hitting all-time highs intraweek on the back of positive earnings surprises.
- Treasury Secretary Janet Yellen says she expects price increases to remain high through the first half of 2022, but rejected criticism that the U.S. risks losing control of inflation.
- US 5-year breakevens increased +14.9bps (-1.0bps on Friday) to 2.9%, the highest level since 5-year TIPS began trading.
- Initial jobless claims in the week ending October 16 came in at 290k (vs. 297k expected), the lowest level since the onset of the the pandemic.
- September's existing home sales rose to an annualised rate of 6.3m (vs. 6.1m expected).

Europe

- Continental European equities rose by +0.9% last week.
- The final Euro Area CPI reading for August came in unchanged from preliminary estimates of +3.0% year-on-year and +0.4% month-on-month.
- Eurozone PMI Composite Output Index fell to 54.3 from 56.2 in September.
- The French manufacturing confidence index was flat at 107 in October, after the previous month's figure was revised upwards.
- 10-year breakeven inflation in Germany increased +9.5 bps (+3.6bps Friday) to 1.91%, the highest level in a decade.

UK

- UK equities fell -0.4% last week.
- CPI data for September came in slightly below expectations at 3.1% (vs. 3.2% expected), with core CPI falling to 2.9% (vs. 3.0% expected).
- UK public sector borrowing rose in September to £21.8 billion, from a revised £16.8 billion in August.
- Bank of England's Chief Economist Huw Pill announced that the rate-setting decision in November is 'live'. The debate on whether to hike is 'finely balanced' he said, adding that the inflation surge is 'uncomfortable'.
- The UK PMI Composite Output Index unexpectedly rose to a three-month high of 56.8, driven by a pickup in services.
- UK retail sales including autos fuel fell 0.2% month on month in September, missing estimates for modest growth.

Rest of the World/Asia

- The benchmark Global Emerging Markets index returned +0.7% last week.
- Japanese equities fell -1.1% last week
- Chinese Equities rose by +3.7% last week.
- China's property market continues to be in focus after home prices fell (albeit by -0.1% in September, their first monthly decline since April 2015.
- Japanese service PMI rose to 50.7 (vs. 47.8 in Sep), which is the first reading over the expansionary 50+ level since January 2020.

Past performance is not indicative of future returns. Source: Bloomberg Finance L.P., returns in local currency unless otherwise stated.

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Market Summary

Asset Class / Region	Currency	Week ending 22 October	Month to date	YTD 2021	12 months
		Cumulative returns			
Developed Markets Equities					
United States	USD	1.7%	5.6%	22.0%	33.0%
United Kingdom	GBP	-0.4%	1.8%	15.8%	30.1%
Continental Europe	EUR	0.9%	4.0%	20.1%	32.5%
Japan	JPY	-1.1%	-1.4%	13.1%	26.2%
Asia Pacific (ex Japan)	USD	1.6%	3.8%	1.6%	15.2%
Australia	AUD	0.7%	1.1%	16.1%	24.4%
Global	USD	1.4%	4.9%	18.5%	32.0%
Emerging Markets Equities					
Emerging Europe	USD	-0.9%	5.2%	29.7%	61.2%
Emerging Asia	USD	1.6%	3.7%	-0.6%	12.2%
Emerging Latin America	USD	-7.1%	-4.2%	-9.5%	12.5%
BRICs	USD	1.0%	4.9%	-2.0%	6.8%
China	USD	3.7%	7.8%	-10.2%	-5.8%
MENA countries	USD	1.8%	3.6%	32.2%	37.4%
South Africa	USD	-0.9%	4.2%	8.5%	25.7%
India	USD	-1.1%	1.9%	27.6%	51.5%
Global emerging markets	USD	0.7%	3.2%	2.0%	16.1%
Bonds					
US Treasuries	USD	-0.4%	-0.5%	-3.3%	-3.1%
US Treasuries (inflation protected)	USD	0.1%	1.2%	4.6%	6.7%
US Corporate (investment grade)	USD	-0.5%	-0.5%	-1.8%	1.3%
US High Yield	USD	-0.1%	-0.3%	4.3%	9.3%
UK Gilts	GBP	-0.3%	-0.3%	-7.9%	-6.4%
UK Corporate (investment grade)	GBP	-0.3%	-0.7%	-4.5%	-0.8%
Euro Government Bonds	EUR	-0.4%	-0.4%	-3.3%	-2.5%
Euro Corporate (investment grade)	EUR	-0.4%	-0.6%	-0.9%	0.2%
Euro High Yield	EUR	-0.2%	-0.6%	3.0%	7.1%
Japanese Government	JPY	-0.2%	-0.2%	-0.3%	-0.3%
Australian Government	AUD	-0.9%	-2.0%	-3.8%	-4.6%
Global Government Bonds	USD	-0.2%	-0.4%	-6.0%	-3.9%
Global Bonds	USD	-0.2%	-0.4%	-4.8%	-2.3%
Global Convertible Bonds	USD	0.4%	1.7%	0.5%	9.8%
Emerging Market Bonds	USD	-0.7%	-0.6%	-4.7%	0.3%

Source: Bloomberg Finance L.P. Past performance is not indicative of future returns.

Market Summary

		Cumulative returns			
Asset Class / Region	**Currency**	**Week ending 22 October**	**Month to date**	**YTD 2021**	**12 months**
Property					
US Property Securities	USD	1.9%	7.4%	31.2%	42.6%
Australian Property Securities	AUD	2.9%	3.2%	15.2%	25.0%
Asia Property Securities	USD	1.3%	1.9%	3.7%	12.0%
Global Property Securities	USD	1.6%	5.3%	19.0%	31.9%
Currencies					
Euro	USD	0.3%	0.5%	-4.9%	-1.6%
UK Pound Sterling	USD	0.0%	2.2%	0.8%	5.0%
Japanese Yen	USD	0.7%	-1.8%	-9.0%	-7.6%
Australian Dollar	USD	0.7%	3.5%	-3.0%	4.9%
South African Rand	USD	-1.1%	2.2%	-0.9%	9.8%
Swiss Franc	USD	0.8%	1.9%	-3.5%	-1.0%
Chinese Yuan	USD	0.8%	0.9%	2.2%	4.7%
Commodities & Alternatives					
Commodities	USD	0.0%	5.7%	44.0%	60.2%
Agricultural Commodities	USD	0.6%	2.0%	26.9%	41.5%
Oil	USD	0.8%	8.9%	65.1%	101.4%
Gold	USD	1.4%	2.0%	-5.4%	-5.7%
Hedge funds	USD	0.2%	0.7%	4.5%	8.8%

Source: Bloomberg Finance L.P. Past performance is not indicative of future returns.

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