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Inflation: the price will be right

Sometimes, the market focuses on a single data point that reflects the spirit of the age. After the global financial crisis, it was US house prices. A year ago, it was the daily number of new confirmed COVID-19 cases. Today, it is the inflation rate, especially in the US. Fahad Kamal, Chief Investment Officer of Kleinwort Hambros, investigates whether inflation may prove lasting and what that might mean for markets.

Inflation is a concern as price pressures are building in several key areas. In the US, money supply growth has reached historical highs of over 20% ever since May 2020, hourly earnings have been rising by 4.6% on average since January 2020, and fiscal spending plans announced since last December amount to over 30% of GDP. In addition, commodity prices have surged 62% over the past twelve months, while supply bottlenecks (for example, in semi-conductors) are sparking fears of steep price rises.

The rapid progress in vaccinations has fuelled hopes that the pandemic will soon be over. Now that more than 50% of the US population has received at least one dose of a vaccine, traffic related to shopping and leisure activities are almost back to normal. This has bolstered business confidence, with one index hitting an all-time high and the fastest rates of new business growth on record in both the manufacturing and the services sectors.

Not surprisingly, some market participants have begun to fret about rising prices. One key measure of inflation expectations (US swap contracts for five-year expected inflation in five years' time, known as 5y5y swaps) has risen from lows of 1.22% in March 2020 to 2.52% today. Another measure (US 10-year breakevens) touched a recent peak of 2.35%.

These increases matter because inflation expectations have enormous influence over monetary policy, bond yields and valuations in the stock market. Bond prices have tumbled as yields on ten-year US Treasury bonds rose from 0.51% last August to 1.47%. This has a knock-on impact on stocks because Treasury yields are a key element for equity investors when calculating the net present value of future cash flows. As a result, growth stocks (where high valuations rely on earnings continuing to grow many years into the future) are particularly vulnerable to rising rates.

However, these inflationary worries are largely a US phenomenon. Market expectations for inflation have risen in the eurozone, but not to the same extent – 5y5y swaps are up from the March 2020 crisis low of 0.72% to 1.58% but remain well below the European Central Bank's 2% inflation target. And the market consensus expects eurozone headline inflation to peak at 1.7% in 2021 before easing back to 1.3% next year. In China, both headline and core inflation are below 1%, and the country is much further ahead in its recovery from the pandemic than its Western counterparts.

In conclusion, we expect prices to rise further this year as economies re-open and pent-up consumer demand is unleashed. But this inflation should prove transitory as many structural factors are still putting downward pressure on prices. Gaps between actual and potential output in the economy are still wide, and there is enormous slack in the jobs market, as well as massive spare capacity in commercial real estate. In addition, ageing populations, supply-chain efficiency and technology-driven productivity gains will continue to exert lasting disinflationary pressures. We believe that inflation will fall back in 2022, which will be good news for businesses and market prices.

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