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US Inflation Pressures Ease for Now

Our weekly view on asset allocation.

20 September 2021

Issued by Wilsons Advisory and Stockbroking Limited (Wilsons) ABN 68 010 529 665 - Australian Financial Services Licence No 238375, a participant of ASX Group and should be read in conjunction with the disclosures and disclaimer in this report.

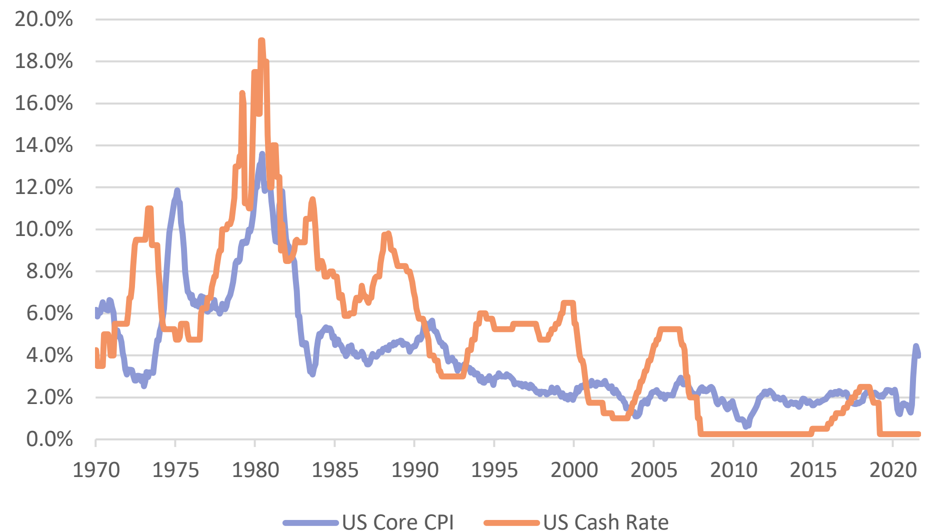
Watching for Cracks in the Low Inflation Thesis

The assumption of relatively low inflation is central to the pricing of interest markets and permeates through the current pricing of virtually all risk assets. So, any signs of a crack in the low inflation thesis (such as the dramatic spike in US inflation in the second quarter) need to be watched closely.

Last week's US August CPI report produced another moderate downside surprise. Core CPI eased 0.3 percentage points to 4.0% year-on-year (YoY) versus a consensus expectation of 4.2% YoY.

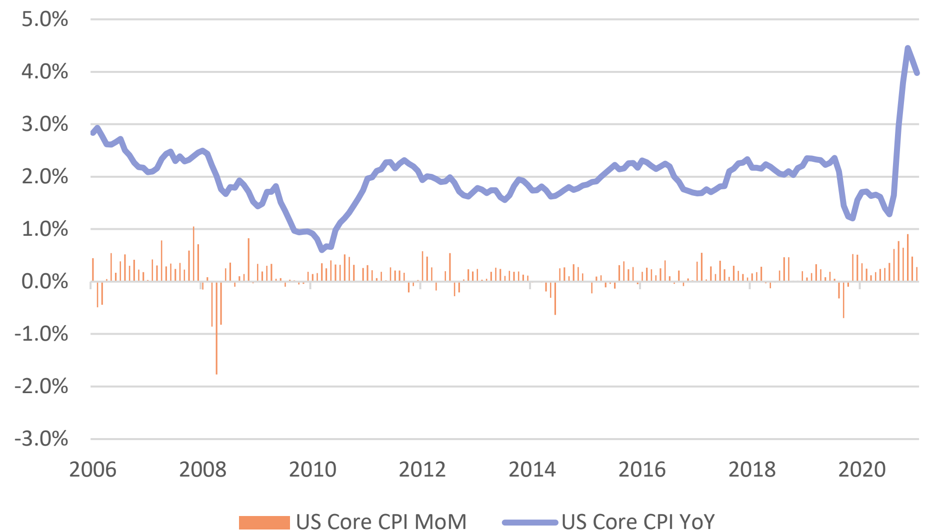
The month-on-month (MoM) changes in both headline and core inflation came in below market expectations. Headline CPI softened to 0.3% MoM from 0.5% while the core figure decelerated to 0.1% MoM from 0.3%.

Exhibit 1: A 40 year decline in Inflation has helped drive a 40 year decline in interest rates



Source: Refinitiv, Wilsons.

Exhibit 2: The recent spike in US inflation appears to be easing



Source: Refinitiv, Wilsons.

Therefore, the August CPI provides some further evidence (following a downside surprise in July) that inflationary pressures peaked in the second quarter, at least for now. This trend supports our argument that the primary forces driving up US CPI recently are largely transitory.

Notably, the weaker inflation result reflects continued easing among sectors that experienced strong upside pressures related to the pandemic, such as airline fares and vehicle prices.

While consumer price inflation readings have begun to edge back, there are still signs of inflationary pressures in the system.

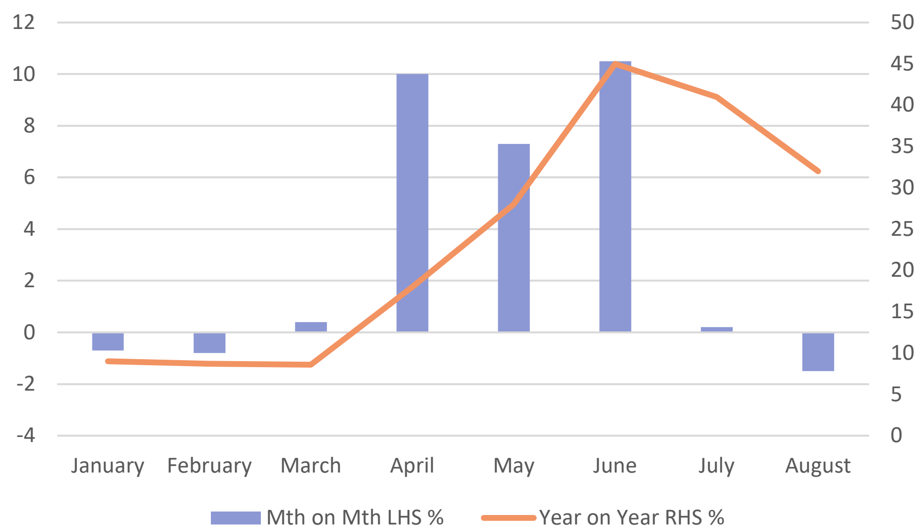
The recently reported producer price index (PPI) increased solidly in August, with the PPI posting its largest annual gain in nearly 11 years.

Bottlenecks in the supply chain remain an issue for producers, and there is a risk that ongoing pandemic disruptions could exacerbate these supply constraints further.

Similarly, while unemployment remains reasonably high, there is some evidence the labour market is quite tight, and wages are picking up in places.

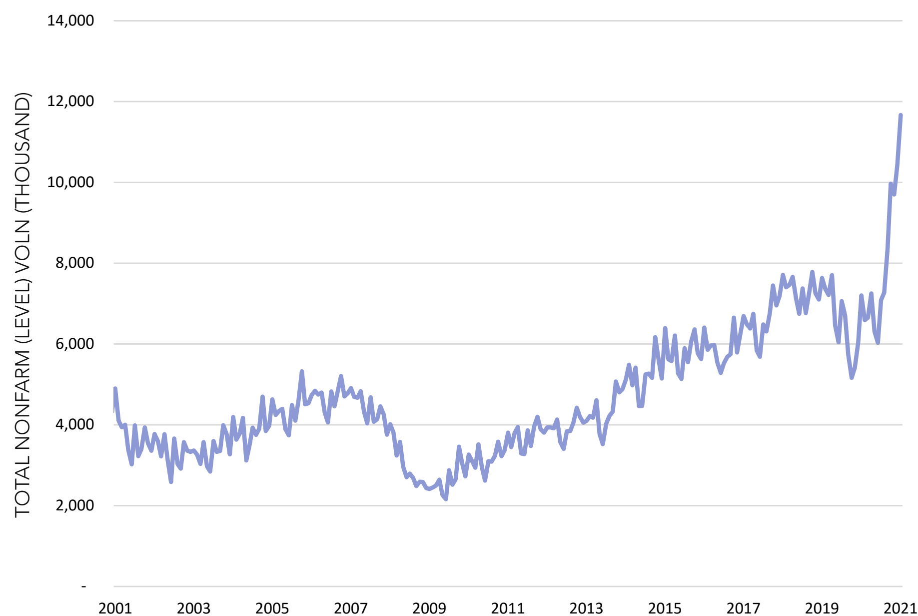
There were a record 10.9 million job vacancies as of the end of July, and there is some evidence that this is forcing companies to boost wages as they compete for workers. Amazon.com (AMZN.O) on Tuesday hiked its average starting wage to $18 per hour from $17, a 6% rise.

Exhibit 3: Pandemic impacted CPI components such as used car prices are now easing



Source: Refinitiv, Wilsons.

Exhibit 4: US job vacancies have risen to a record high despite an elevated unemployment rate



Source: Refinitiv, Wilsons.

While anecdotes suggest some significant pockets of age pressure and the Atlanta Fed's wage growth tracker has been accelerating since May, it remains broadly within the range observed since 2016. An easing in the pandemic may help make labour easier to attract in the coming year. Thus, it is too early to conclude that a step-change in wage inflation is underway; however, the perky pace of wage gains "early in the cycle" does bear watching in our view.

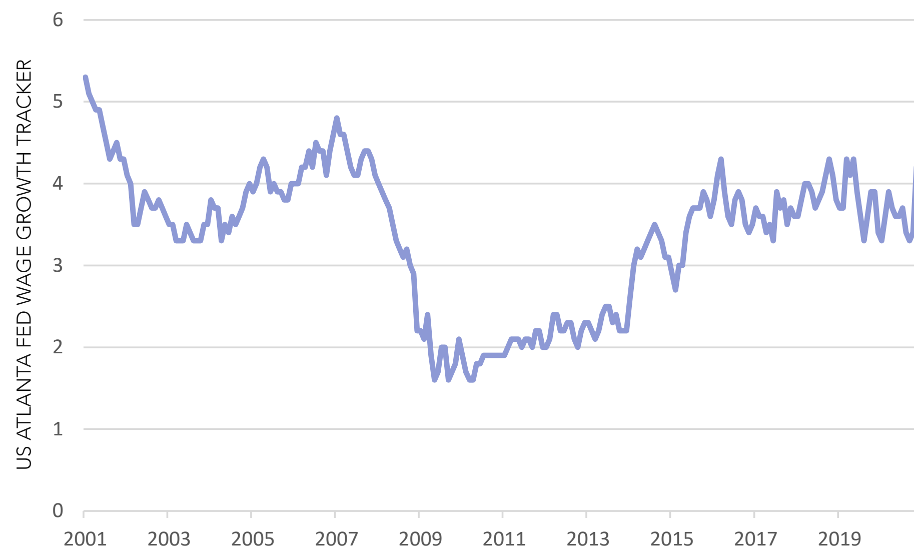
The Change in Fed Thinking – A More Flexible Approach to Inflation

The Fed has signalled it is wary of tightening monetary policy too soon in this cycle, believing they tightened prematurely in the last cycle. As a result, growth slowed sooner than was necessary, without actually having seen much in the way of inflation. There now seems to be a commitment to let the economy run, to prioritise the goal of full employment. This has been reflected in language about how they will tighten only when they see inflation.

The Fed will, in effect, be willing to use signs of rising inflation as a guide to the level of "maximum employment" rather than use their "estimate" of full employment as a signal of future inflation pressures. This is an important shift in emphasis. While not a certainty, this more reactive (inflation) policy stance risks the Fed playing catch-up at some point in this cycle.

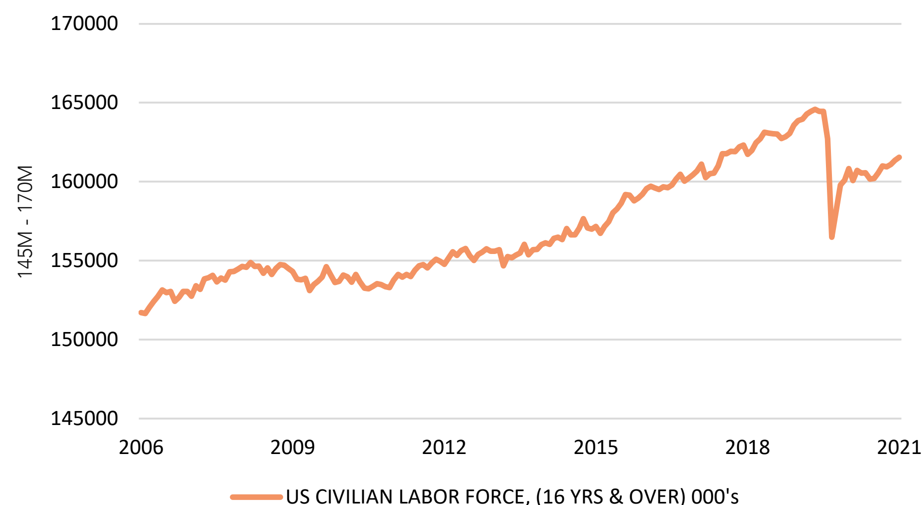
From this perspective, there is some risk that the Fed, and markets, have been lulled into complacency by the very slow pace of recovery and lack of inflation that occurred after the global financial crisis. Recoveries from financial crises tend to be weak because the damaged system has to rebuild its capital, slowing down the recovery process. But recovery from a virus could be quite different. Once (if) the virus has been quelled, there is reason to think that the economy will snap back quickly. It is possible the pace of the tightening will more closely resemble soft landings before the GFC. This may mean that once rate hikes start, there is a risk that they prove faster than the market is currently pricing.

Exhibit 5: US wage growth has picked up quite sharply



Source: Refinitiv, Wilsons.

Exhibit 6: The Fed wants to run stimulative policy until the labour market approaches full employment



Source: Refinitiv, Wilsons.

Still plenty of reasons for inflation to stay moderate to low

To be clear, we do not think the US economy is on the cusp of major inflation breakout. There are still plenty of structural forces likely to keep inflation broadly in check. Technology innovation and demographics remain the two strongest downward pressures on inflation in our view. Technology should continue to drive down the cost of many goods and increasingly certain services as labour is replaced with capital/ technology and processes are made more efficient. Ageing demographics should constrain the growth potential of most economies over the longer term. This subdued long-term trend in aggregate demand is also likely to be disinflationary (e.g.Japan).

Notwithstanding these secular forces, we think it is plausible that we see a bit more inflation over the next few years than we saw in the last cycle and likely more than is currently priced into the interest rate markets.

Positioning for the Ebb and Flow of Inflation

Some of the sharp inflationary pressures that emerged in Q2 appear to be easing for now. This takes some pressure off the Fed and is a near-term support for risk assets.

While the Fed now appears quite close to tapering its bond purchases it is in no hurry to raise rates and will likely use inflation to help guide them toward their newly elevated goal of full employment.

Read QE, Tapering and Zero Cash Rates - A 2022 Roadmap

Markets are suggesting a US cash rate lift-off in late 2022 or early 2023. This seems a fair assessment, albeit it could quite conceivably be a little earlier. Importantly, the pace of tightening assumed by the market once it begins is very slow. There is a risk that once it gets going, it will be quicker than the market is pricing and will end with a significantly higher terminal Fed Funds rate than currently priced.

In short, this scenario is a bearish medium-term story for bond markets, given current interest rate levels. This could also end up being a bearish story for risk assets, albeit this scenario is still something of a risk case and may not come into focus for some time.

With inflation edging off its highs, growth good and rates low, we still believe we have a decent environment for risk assets. We do not see a need to aggressively batten down the hatches for accelerating inflation at present.

We believe it would be prudent to start installing some robust inflation hedges that often have other positive drivers, such as attractive valuations and positive leverage to the business cycle.
These include:

- Inflation protected alternative fixed interest strategies
- Private debt (floating rate)
- Exposure to the value style of investing
- Uncorrelated growth assets (market-neutral hedge funds)
- Real assets (infrastructure and real property)
- Commodity exposure including gold (and/or gold stocks) and broader commodity-related exposure. The (underperforming) energy sector looks particularly attractive in our view.

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