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Inflation – Transitory or Persistent?

- Supply bottlenecks as a result of Covid may lead to higher inflation risks as the global economy reopens.
- Bond markets are pricing in higher than target levels of inflation with US 5 year break evens peaking in May.
- Commodities across the board have seen record rallies over the last 12 months.
- Investors should be thinking about how to manage the inflation risks in their portfolios.

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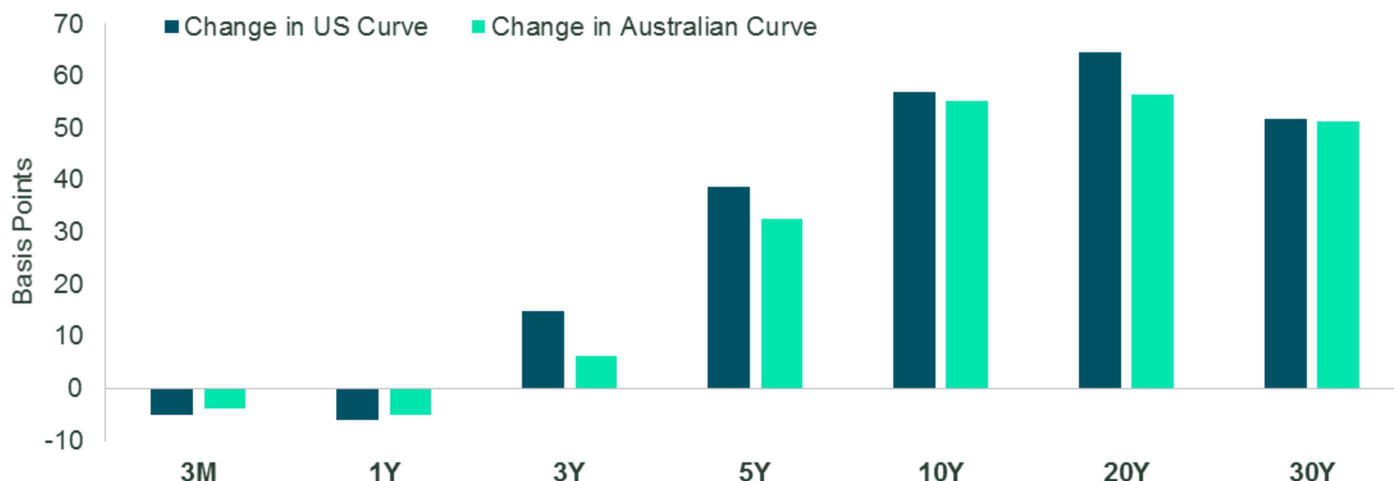
The big talking point in the market at the moment is inflation. Over the last 40 years inflation has been generally contained within or below the targets we have seen set by central banks but recent signs point to higher levels of inflation around the world.

Investors are taking note because inflation has a direct impact on the purchasing power of every dollar we earn. As prices rise with inflation, it costs us more to buy goods and services which means every dollar we have, doesn't stretch as far.

Central banks also keep an close eye on inflation as rising prices could force central banks like the US Federal Reserve (Fed) into raising interest rates. There are additional pressures as well. In March, US President Joe Biden signed a US$1.9tn economic relief bill that saw the government send US$1,400 cheques to most Americans. With increased levels of savings through the pandemic, consumers are itching to get out and be able to enjoy some retail therapy. The economic reopening along with a pickup in retail sales could drive prices higher.

Financial markets too are pricing in a post-Covid economic recovery and the potential for “reflation”. Long-term bond yields are up have been on the rise since the start of the year with the yields on the 10 year bond in both the US and Australia having both risen by around 55bps and the 20 year bond in the US by around 65bps.

Figure 1: Change in Yields So Far in 2021

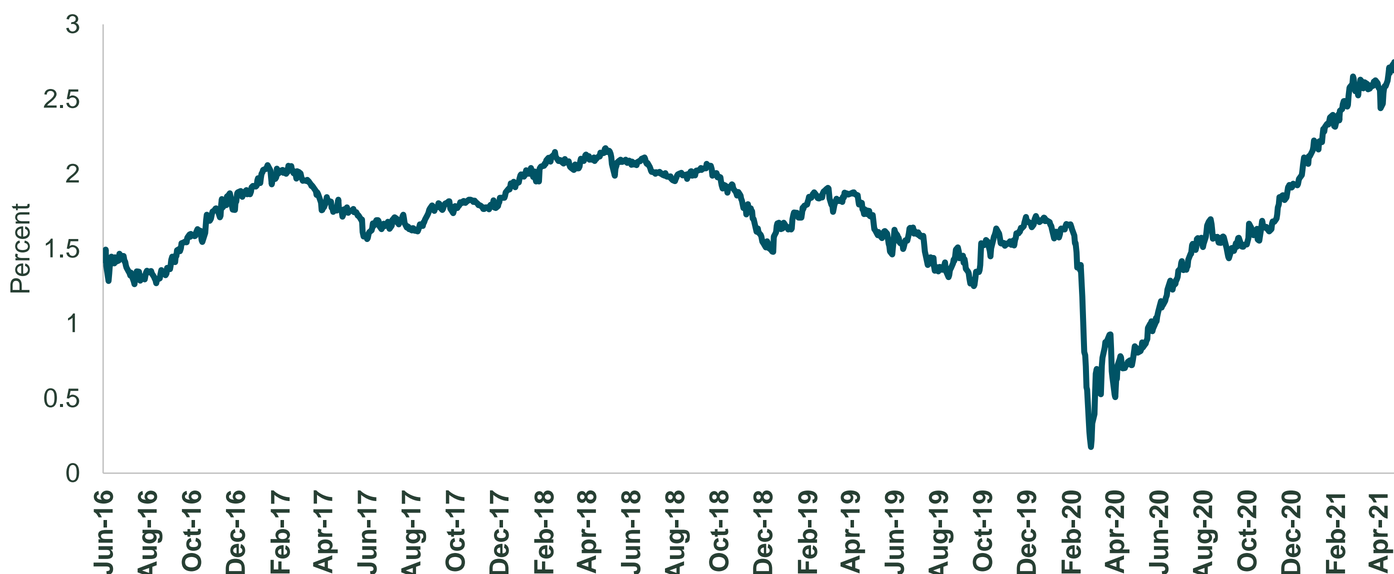


Source: Bloomberg Finance L.P., State Street Global Advisors as of 9 June 2021.

Yields are expected to rise if markets are anticipating higher levels of inflation going forward. This is because investors purchasing power is eroded by higher inflation - so they will demand higher yields to compensate for the inflation risks they see on the horizon. And there are more direct signals in the market.

The US 5-Year Breakeven Inflation Rate which reflects a measure of expected inflation peaked mid-May 2021 at just under 2.8 and ended the month at 2.4, still above the average target set by the Fed of 2%.

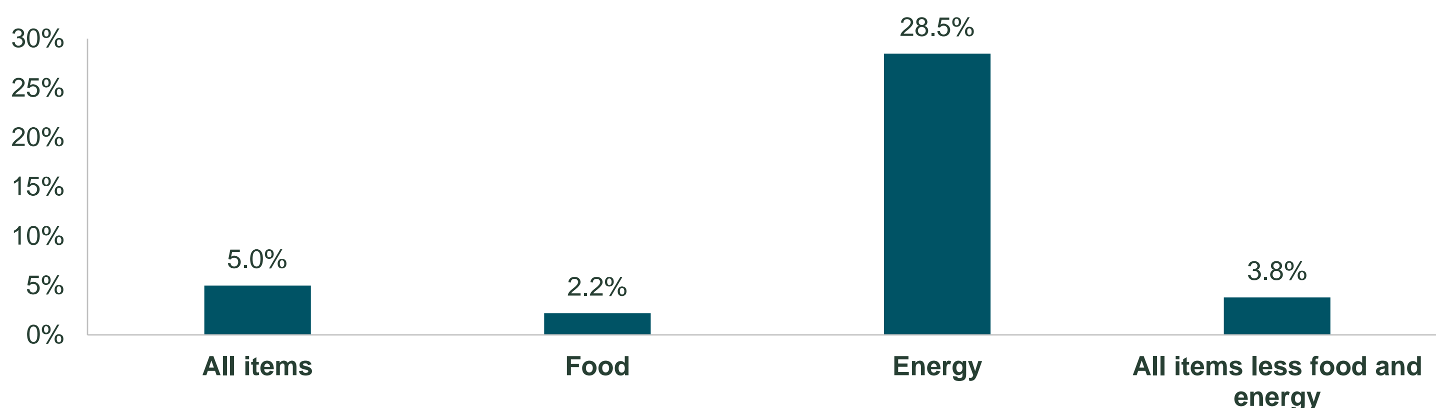
Figure 2: US 5-Year Breakeven Inflation Rate



Source: Bloomberg Finance L.P., as of 31 May 2021.

There are other signals that inflation is picking up as well. Some argue that the current pick-up in inflation (the 12 month percentage change in the US consumer price index was around 5% as of the end of May), is transitory and point to events like the temporary closure of the Suez canal in March this year. That was significant not only because it saw a container stuck for 6 days, but also because 12% of global trade passes through the Suez canal so this is likely to have caused significant short term supply chain disruption. Other signals can be found in the breakdown of the inflation figures themselves. The 12 month percentage change in the energy component of the US Consumer Price Index was 28.5%.

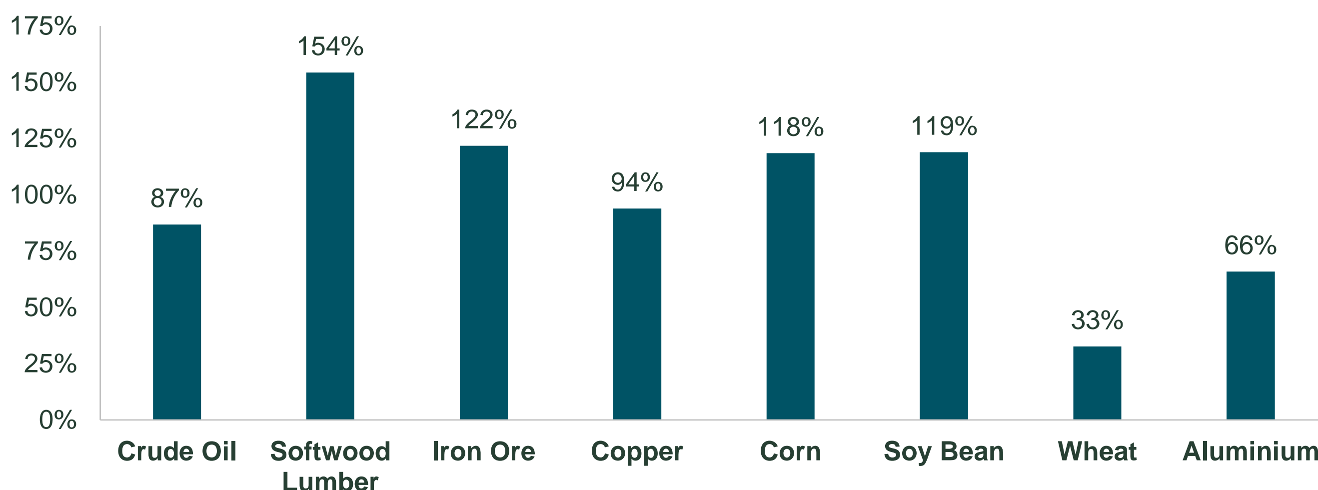
Figure 3: 12 Month Percentage Change – Consumer Price Index (selected categories, not seasonally adjusted)



Source: US Bureau of Labor Statistics as of 31 May 2021.

And it's been commodities – often regarded as an inflation indicator as well as an inflation hedge that have seen a rapid rise in prices over the last 12 months. Across-the-board, the rise in commodity prices to the highest levels since the start of the pandemic is creating increased cause for concern.

Figure 4: Commodity Price Rises (12 months to May 2021)



Source: Bloomberg Finance L.P., World Bank as of 31 May 2021

At some stage, the increase in raw materials will feed through to an increase in the price of final products.

Going forward, central bankers must decide whether they can keep looking past the signs indicating higher levels of inflation and decide if they need to move faster to cool demand through rate rises and other moves. With the economic recovery underway, indications are now that we will see two rate rises by the end of 2023 but that is over a year away. In the interim, higher prices for raw materials will probably result in temporary inflation pressures and we expect to see inflation settle slightly higher than investors may be anticipating.

Investors looking to manage inflation risks in their portfolios might want to consider more defensively orientated strategies that can provide some level of inflation protection.

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