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Market Update

Inflation – a Bounce or a Trend?

Inflation is the dominant story in financial markets currently, with much debate surrounding a current upswing in prices and whether this will be a transitory effect as demand bounces back from the depths of last year's economic mothballing, or whether we are at the start of a sustained inflationary period, not seen since the 1970s.

Summer Surge

In the short term there are few who do not expect a surge in price levels over the summer months. With inflation numbers calculated relative to the level of prices 12 months ago, which was the height of the pandemic, these "base effects" would create a significant jump in inflation on their own. If this is then combined with the rush in buying that is expected as consumers are given the chance to spend their amassed savings and with the Covid and Brexit related supply bottlenecks, a surge in short term inflation numbers can hardly be considered a surprise.

US Surprises

Numbers in the UK so far have been relatively muted, with CPI increasing from 0.7% in March to 1.5% in April. In the US however, the numbers have been more eye-catching with consumer prices rising at 4.2% for the 12 months to April. This figure is the highest since 2008 and created a wave of panic with bond markets and interest rate sensitive stocks, such as large US tech companies, the hardest hit. This high figure raised fears that such has been the extent of stimulus in the US in response to the pandemic that an overheating economy may be developing.

An Open Question

This is where the debate now centres. Yes, interest rates remain at rock bottom levels, Quantitative Easing programmes remain at high levels and governments continue to embrace hugely stimulatory fiscal policies. Yet, beyond the initial bounce back as economies reopen, consumer spending is likely to fall to normal levels, worker productivity is likely to stay low, ageing populations will continue to be a deflationary factor and with unemployment rates still elevated, there is unlikely to be sustained wage inflation. Consequently whether the initial jump in inflation proves persistent remains an open question.

Average Inflation

For markets this matters because the path of inflation is likely to determine the necessary path of interest rates. So far, central banks are of the view that the jump in inflationary is just a short term event and therefore are holding firm on low interest rates. In addition, with the US Federal Reserve's inflation policy now seeking to achieve an *average* level of 2%, there is significant scope to tolerate a moderate overshoot in the price level over the coming years.

Market Impact

Should inflation prove stubbornly or excessively high however then the Fed, along with the rate setting bodies of other countries, would be forced to take action. In this event, those assets which have done well in a low rate environment, will likely struggle. This is likely to be especially felt in long dated government bonds, as well as in high growth equities. A glimpse into these trading patterns has been evident in recent weeks, the extent to which it takes hold will be a highly important question for markets.

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