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30th September 2021

Market Update

Inflation is Transitory…

As anyone who has read previous editions of our market updates, or who has kept abreast of financial news over recent months will know, the emergence of inflation has been the main story occupying markets over this time. Central banks, however, have been largely dismissive of this occurrence, with the bulk of price rises linked to one-off covid-linked events. Consequently, rising inflation has been tolerated as merely a transitory effect. The consensus has been that central banks will not need to raise interest rates or pare back quantitative easing any time soon. Markets, therefore, have been sanguine. As we have previously highlighted, however, if inflation proves to be longer lasting than expected, monetary policy may be forced to tighten at a quicker pace and so markets could face greater challenges.

…Until it's Not

Such a possibility now appears to be emerging. The mantra of transitory is proving to be perhaps temporary, after all. While we are not yet at the point of widespread wage rises fuelling an inflationary cycle, there is growing evidence that rising prices are more persistent than would be were it just for the bounce back from the pandemic lows of last year. The tone of central banks is starting to shift too, with both the Bank of England and the US Federal Reserve indicating that interest rates may well rise faster than previously thought.

Demand and Supply

With consumers and businesses increasingly confident over the outlook for the economy, demand is high. Supply chains, however, continue to be challenged with bottlenecks particularly apparent in container shipping and semiconductors (vital for car production). Add into this surging energy costs and in the case of the UK specifically, HGV driver shortages, and price rises are becoming engrained.

Medium Term

Expectations are still that many of these issues will ease over the coming months, yet with the coming years likely to experience both broad corporate and government investment (austerity remains out of fashion), the case for longer lasting inflationary pressures is likely to build.

Market Reactions

The mood of markets has therefore changed and the clearest indication of this is in bonds. The yield on government bonds can broadly be used as a guide to long term interest rate expectations. Bonds have been falling in value over recent days leading to higher yields and this has been especially the case in longer dated bonds. This can be interpreted as markets suggesting interest rates will need to rise and to stay at elevated levels as inflation is increasingly likely to be a persistent factor.

Early Signs

It remains our view that inflation will continue to rise over the coming months – perhaps peaking at 4% or slightly higher, as measured by UK CPI – and then will likely fall back in early 2022. Nonetheless, it is the level at which it then settles which will be most important to financial markets and the wider economy. If inflation falls to below 2% then central banks are likely to abandon any plans for continued tightening, yet significantly above this level and interest rates will be set higher. Should this materialise, bond markets will come under renewed pressure, while areas of the equity market more attuned to interest rates, such as many highly valued technology companies, could also face difficulties. This week has shown the first movement in this direction, and while it would be too early to call it a trend, such a thing could yet emerge. Consequently, inflation looks set to remain headline news for the coming months and markets will be paying close attention.

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