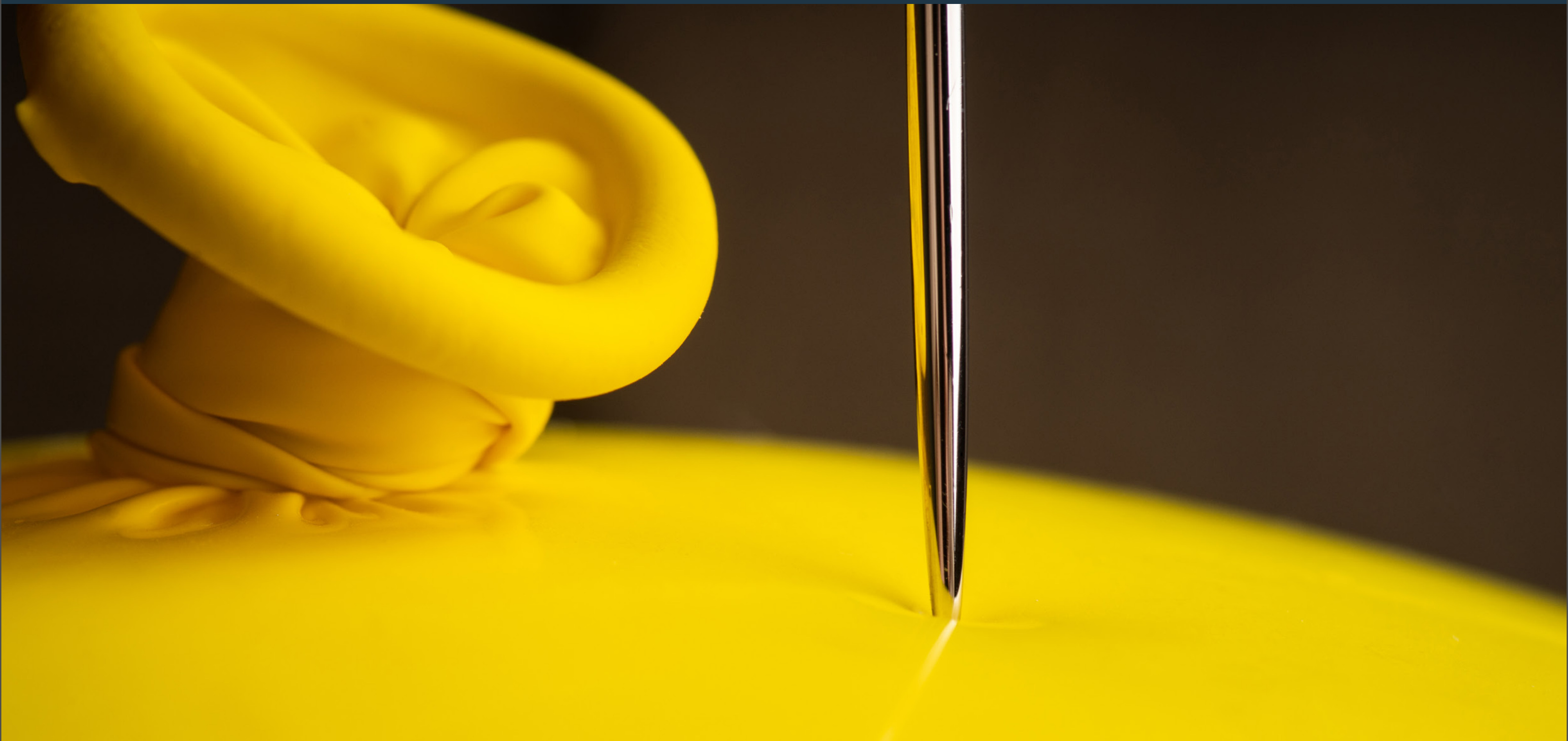
Q&A: Should one blockbuster inflation reading warrant a change in asset allocation? We don't think so…

AVIVA INVESTORS

May 2021



A blockbuster US inflation reading has sent shock waves through financial markets. With investors now on edge as to what this might mean for monetary policy, we think the spike in inflation will be temporary. Find out more with David Nowakowski (DN), Senior Investment Strategist and Fabio Faltoni (FF), Multi-asset & Macro Investment Director.

FF: Were the latest inflation numbers really that large?

DN: Yes, relative to history, the move was big. The April Consumer Price Index figure was much stronger than had been expected, at 0.8 per cent on a month-on-month basis (versus 0.2 per cent expected), which in turn sent the year-on-year rate to 4.2 per cent. This is the highest it has been since September 2008. Core inflation didn't provide any respite either, with the 0.9 per cent monthly increase being the fastest pace of core price rises since September 1981, sending the annual number up to 3 per cent (the highest since January 1996).[1]

FF: What were the main factors behind the increase in prices?

DN: In a word: "re-opening". Strong demand across multiple sectors, as well as post-pandemic supply chain disruptions, helped push prices to record highs. In particular, the biggest increases were in used vehicles (affected by the global semiconductor shortage's limiting auto production) and service sectors being disproportionately impacted by shutdowns (including lodging and airfare) – now that they are re-opening, hotels and airlines have been able to raise prices by ten per cent. Energy and housing didn't actually add much – although they might rise in future months.

FF: What was the market reaction?

DN: Bond yields, which had retraced in April after rising significantly over the course of the first quarter, renewed their move higher. The inflation news also added further fuel to the sell-off in equity markets, especially tech stocks which have shown to be inversely correlated to bond yields and concerns about economic overheating risks. However, European banking stocks advanced to a post-pandemic high as sovereign bond yields in Europe hit fresh two-year highs. Inflation breakevens, a measure of inflation expectations, also inched higher, with the 10yr US breakeven touching 2.5 per cent – levels not seen in nine years.

FF: The market reaction seems to suggest investors are continuing to position for a change in the inflation regime. However, Federal Reserve communications imply "transitory" factors are at play. What is your take?

DN: Understandably, investors are now on edge as to what this might mean for monetary policy. However, the Federal Reserve (Fed) officials we heard from after the inflation release predictably downplayed the report and repeated their mantra that any rises in inflation would prove temporary. For instance, Vice Chair Richard Clarida said that even though he was surprised by the reading, he expected "inflation to return to – or perhaps run somewhat above – our two percent longer-run goal in 2022 and 2023", with this outcome being "entirely consistent" with the Fed's new framework.

In our House View[2] published last month, we highlighted the potential for a variety of factors, such as energy prices, affecting the annual comparison for both headline and core measures of inflation over the course of 2021, pushing measured inflation temporarily above target in most major economies. This is partly what we saw happen with this reading. The next few months will also show high annual comparisons, and (probably) monthly as re-opening continues. This won't happen next year, and so it should be transitory in that sense.

Much like the Fed officials, we think annual inflation rates should start edging lower as we move through the third quarter of 2021 and the economic extreme of lockdown is no longer included in the calculation.

Just how temporary that proves to be will depend on the pace of recovery. In the US, we expect the output gap to turn positive by the end of 2021, with the euro zone to follow around a year later. That could put moderate upward pressure on underlying inflation in 2022 and beyond – and while we see a risk that could be too high for comfort, we don't see runaway inflation happening either.

Assuming inflation is moderate – CPI in the high 2 per cent or even low 3 per cent range, with PCE prices rising around 2.5 per cent for a while – it would be welcomed by central banks as it shouldn't result in second-round effects like rapidly rising wages and de-anchored expectations.

FF: What would change your view?

DN: As mentioned above, it all depends on the extent to which spare capacity is eroded. Certain sectors are feeling constraints and passing on input price increases, but others still have slack. To this end, we are monitoring job reports closely.

The surprisingly weak US hiring report released in the first week of May reinforces the Fed's view that employment is far from 'full potential'. Based on the criteria laid out by Chair Jerome Powell (and echoed by other Fed officials), it would take more than just a strong May jobs report to shift their view. Sizable upward revisions to March and especially April, as well as a few more months of lower unemployment would be necessary get the Fed and our team to materially reassess the current expectations. It is important to remember that the Fed's new framework means that they do not want inflation to be transitory – they want to see "moderately above" target inflation for a sustainable period.

FF: In that case, what are your expectations on asset purchase tapering and the potential for interest rate hikes in the US?

DN: We expect tapering announcements from the Fed before the end of the year and for it to take about 12 months to complete. That should set the stage for lift-off – the first hike – and gradual interest rate hikes after that. There is some potential for repricing since a pace of two hikes per year, as implied by Eurodollar futures and swaps, is too small (if the Fed does actually get to the first hike, of course).

FF: Since your macro outlook has not changed, would it be fair to assume that your view on risk assets hasn't either?

DN: That is correct. We are supportive of risk assets, with a preference for equities over credit. Even though equity returns should slow from here, we expect them to remain positive as real rate pressures on valuations are balanced by a bright outlook for earnings – which was confirmed in the latest reporting season.

From a regional perspective, we are slightly underweight emerging markets, while are somewhat more overweight the US and UK markets, where domestic growth differentials, strong policy support and strengthening global trade should be favourable. From a sector perspective, we expect "high growth" stocks to underperform and "value" and "cyclical" stocks to continue their recent outperformance.

FF: What about duration?

DN: Government bond yields have risen in recent months, reflecting the brighter economic outlook and increased fiscal support, particularly in the US where the infrastructure bills are expected to be passed in the second half of the year in some form. That means more growth and more bond supply, though some taxes might be added to the mix.

Even after this latest treasury sell-off, we think that longer-term bond yields can rise further; yes, the US 10-year is over 100 basis points higher than its trough in August 2020 – but a lot has changed since then, and we shouldn't expect the US or global economy to return to its pre-pandemic state. With most central banks set to keep policy rates at the effective lower bound for some time, there remains a limit as to how far yields can rise, near-term. That said, we are approaching interest rate hiking cycles in several G10 markets; as such, we are modestly underweight duration.

1. Source: Bloomberg
2. 'House View Q2 2021' Aviva Investors, April 8, 2021. https://avivainvestors.com/en-gb/views/house-view/

The views and opinions expressed here are those of the authors and do not necessarily reflect the official position of the wider Aviva Investors Investment team.

David Nowakowski
Senior Strategist, Multi-asset & Macro
Joined investment industry: 1995
Joined Aviva Investors: 2018

Main responsibilities

Working in the Investment Strategy team, David contributes to the 'House View' and the idea generation process across Developed and Emerging bond and currency markets, supporting the AIMS fund range.

Experience and qualifications

Prior to joining Aviva Investors, David was a director at Barings with responsibility for idea generation and scenario analysis for Fixed Income portfolios with a particular focus on currency, rates and credit strategies, as well as contributing to firm-wide macroeconomic views. Beforehand, David held numerous roles in investment management in New York and London, including Lazard Asset Management and The Rohatyn Group. He was also senior director of research at Roubini Global Economics, and has advised sovereign and corporate clients during his time at Citigroup/Salomon.

David holds a Master's degree in Physics and a Bachelor's degree in Physics and Mathematics from Harvard University, and a MSc in Economics from LSE.

Fabio Faltoni
Multi-asset & Macro Investment Director
Joined investment industry: 2014
Joined Aviva Investors: 2016

Main responsibilities

Fabio is an Investment Director focusing on our Multi-strategy capabilities. In his role, he works closely with our portfolio managers to articulate their investment process, portfolio positioning and investment performance to clients and consultants around the world. He is based in London.

Experience and qualifications

Fabio joined Aviva Investors in August 2016 after having previously spent 2 years at ICAP plc in institutional sales focusing on credit default swaps. Fabio holds a BSc in International Economics, Management and Finance from Bocconi University as well as an MSc in Finance from Grenoble Graduate School of Business. He is also a CFA Charter Holder.

Important information

Except where stated as otherwise, the source of all information is Aviva Investors Global Services Limited (AIGSL). Unless stated otherwise any views and opinions are those of Aviva Investors. They should not be viewed as indicating any guarantee of return from an investment managed by Aviva Investors nor as advice of any nature. Information contained herein has been obtained from sources believed to be reliable but has not been independently verified by Aviva Investors and is not guaranteed to be accurate. Past performance is not a guide to the future. The value of an investment and any income from it may go down as well as up and the investor may not get back the original amount invested. Nothing in this material, including any references to specific securities, assets classes and financial markets is intended to or should be construed as advice or recommendations of any nature. This material is not a recommendation to sell or purchase any investment.

In Europe this document is issued by Aviva Investors Luxembourg S.A. Registered Office: 2 rue du Fort Bourbon, 1st Floor, 1249 Luxembourg. Supervised by Commission de Surveillance du Secteur Financier. An Aviva company. In the UK Issued by Aviva Investors Global Services Limited. Registered in England No. 1151805. Registered Office: St Helens, 1 Undershaft, London EC3P 3DQ. Authorised and regulated by the Financial Conduct Authority. Firm Reference No. 119178. In France, Aviva Investors France is a portfolio management company approved by the French Authority "Autorité des Marchés Financiers", under n° GP 97-114, a limited liability company with Board of Directors and Supervisory Board, having a share capital of 17 793 700 euros, whose registered office is located at 14 rue Roquépine, 75008 Paris and registered in the Paris Company Register under n° 335 133 229. In Switzerland, this document is issued by Aviva Investors Schweiz GmbH.

In Singapore, this material is being circulated by way of an arrangement with Aviva Investors Asia Pte. Limited (AIAPL) for distribution to institutional investors only. Please note that AIAPL does not provide any independent research or analysis in the substance or preparation of this material. Recipients of this material are to contact AIAPL in respect of any matters arising from, or in connection with, this material. AIAPL, a company incorporated under the laws of Singapore with registration number 200813519W, holds a valid Capital Markets Services Licence to carry out fund management activities issued under the Securities and Futures Act (Singapore Statute Cap. 289) and Asian Exempt Financial Adviser for the purposes of the Financial Advisers Act (Singapore Statute Cap.110). Registered Office: 1 Raffles Quay, #27-13 South Tower, Singapore 048583. In Australia, this material is being circulated by way of an arrangement with Aviva Investors Pacific Pty Ltd (AIPPL) for distribution to wholesale investors only. Please note that AIPPL does not provide any independent research or analysis in the substance or preparation of this material. Recipients of this material are to contact AIPPL in respect of any matters arising from, or in connection with, this material. AIPPL, a company incorporated under the laws of Australia with Australian Business No. 87 153 200 278 and Australian Company No. 153 200 278, holds an Australian Financial Services License (AFSL 411458) issued by the Australian Securities and Investments Commission. Business Address: Level 30, Collins Place, 35 Collins Street, Melbourne, Vic 3000, Australia.

The name "Aviva Investors" as used in this material refers to the global organization of affiliated asset management businesses operating under the Aviva Investors name. Each Aviva investors' affiliate is a subsidiary of Aviva plc, a publicly- traded multi-national financial services company headquartered in the United Kingdom. Aviva Investors Canada, Inc. ("AIC") is located in Toronto and is registered with the Ontario Securities Commission ("OSC") as a Portfolio Manager, an Exempt Market Dealer, and a Commodity Trading Manager. Aviva Investors Americas LLC is a federally registered investment advisor with the U.S. Securities and Exchange Commission. Aviva Investors Americas is also a commodity trading advisor ("CTA") registered with the Commodity Futures Trading Commission ("CFTC") and is a member of the National Futures Association ("NFA"). AIA's Form ADV Part 2A, which provides background information about the firm and its business practices, is available upon written request to: Compliance Department, 225 West Wacker Drive, Suite 2250, Chicago, IL 60606.

200889 - XXXXXXXXXXXXXX