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OF GLOBAL ECONOMICS

WITH

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Credit Bracing for Higher Inflation

- **US headline inflation due this week to be just shy of 5%**
- **More pipeline inflation evident as parts of the world runs short of products and workers.**
- **US year-end inflation forecast to still be around 2.5-3%.**
- **We suspect the Fed will have to relent and allow the curve to steepen if only to endorse an inflation, rather than a deflation market mindset.**
- **High yield bond markets may struggle to provide significant if any return, but equally we do not expect any sought of rout.**

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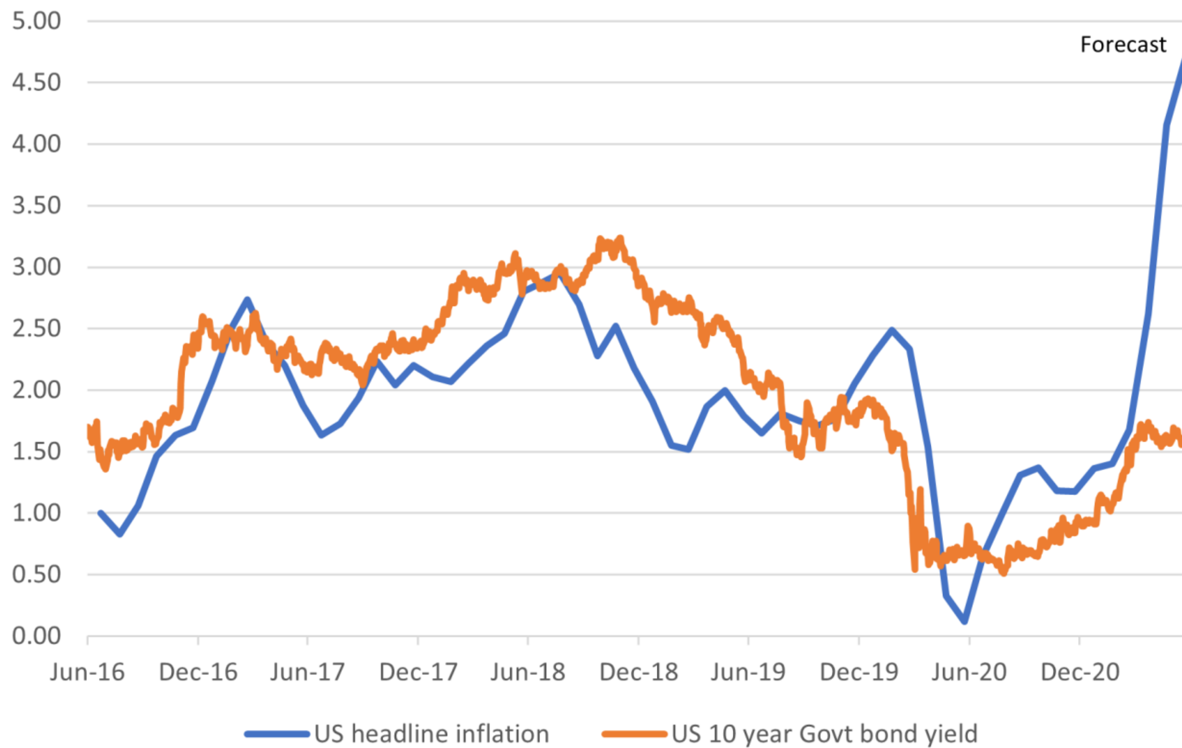
Credit markets have remained strong despite the evident pick in inflation – the future could be more challenging. This coming week economists expect US inflation to hit a near 5% level for May. A few months ago, the economists' consensus forecast for the peak in inflation had been no higher than around 3.8%. The Fed in particular will be challenged to respond if as now seems more likely inflation persists. Credit markets are on watch.

Chart 1: US government bond yields have s far failed to track inflation



Source: Bloomberg

We see further pipeline inflation pressures. Around the world, companies are running extremely low levels of inventory relative to the level of orders. It is only a matter of time before this pressure will likely translate into higher prices. Companies cannot get hold of either vital components or a product they urgently need to meet demand. Stories abound of the very substantial increase in shipping rates due to a shortage of vessels. Recently Bloomberg recently reported that the cost to move goods in a shipping container from Asia to Europe had shot above the $10,000 level for the first time on record, that's an increase of 485% from a year ago.

As an interesting anecdote on the inflation theme, there are evident shortages of US truck drivers. The US Journal of Commerce reports, "The average weekly hours worked by nonsupervisory employees at trucking firms, including drivers and dock workers, rose to 43.3 hours in April, a new record high after an increase to 43 hours per week in March. That is an hour per week longer than the 41.9-hour average from 2015 through 2019. **Trucking companies are increasing pay, and some carriers have raised their per-mile pay rates more than twice in the past 12 months".**

Last week's US employment report for May showed similar aggregate trends. The average

workweek remains elevated at 34.9 hours, and average hourly earnings rose 0.5% for the month, now at a 4.5% annualised pace. However, labour force participation fell another tenth to 61.6%.

Another reason to believe that we will see further inflation pressures through the summer is that the world faces a resurgence of demand after a lull in April. US and euro area retail sales so sharp contractions in April due to the continued lockdowns in the Europe euro area and secondly the lack of government payouts in the United States in that particular month.

With very evident inflation pressures, attention has turned to think about which major central banks will blink first and start to tighten monetary policy. **Forecasts for US inflation at year-end have shifted above 3.0%.** Just think about that for a moment; economists expect inflation to remain elevated even when some of the most significant impacts of COVID have passed. Such forecasts are going to put increasing pressure on the Fed to do something. Only time will tell if the Fed feels that it needs to dial down at least some of the extraordinary levels of accommodation it has provided the market.

The European Central Bank meets this week where they will discuss the pace of their quantitative easing. The market is anticipating that they will maintain their current purchase pace of a run of around 80 billion euro per month. However, it is difficult to see the ECB making a significant policy shift when inflation, even on their forecasts, is still likely to be significantly below the 2% target economists expect the ECB forecast for 2023 to move to no higher than 1.5%.

Credit investors are bracing for the beginning of a tapering discussion from the Fed in June. We remain of the view that the Fed will have to countenance some rise in long term interest rates if only to cement a more pro-inflation mindset into the market. A US 10 year of 1.90% before year end still looks quite possible.

With the long end of the curve still well-behaved (the 10Y yield ended last week at 1.55%), the surge in new issuance continues. By last week, $47 billion in new high-yield bonds had been priced and issued, the busiest May ever. It was undoubtedly a case of sell/issue in May for corporates, but there is no indication that it will abate. The expectation is that issuance from June onwards will continue to be higher than its historical pace.

The performance of the credit market reflects the dual impact of the liquidity provision that the Fed had provided through the COVID crisis and the very favourable economic backdrop that the broader policy interventions subsequently have created. Bloomberg reports that the CCC-rated credit bucket, the lowest-rated credit bonds (apart from the ones already in default), is on track to report its 14th straight month of positive absolute returns, the second-best streak ever. The record is 16 months, recorded in the recovery period of the Savings and Loans crisis in the early 1990s.

At the end of May, the lull in issuance saw spreads rally close to the lows for the year. The Bloomberg Barclays US HY Index spread to Treasury dropped again below 300 basis points, ending last week at 296 bps, compared to the low for the year at 284 bps. **It is tempting to ascribe the surge in issuance as a cash grab by corporates to gear up balance sheets while**

liquidity is plentiful. However, it is also true that many fixed-income investors still face a dearth of yield and remain willing to commit to the market against a backdrop of strong growth.

History has shown that default rates are modest to low when the economy is growing strongly, and the current episode is no exception. The expected default rate as projected by Moody's is now below 3% for the 12 months from here. That is more or less in line with the historical average for the asset class. However, there appears to be the possibility that the number is still a little on the high side. JP Morgan's research points out that the actual number of defaults and dollar amount affected is very mild. It reports that so far this year, seven companies have defaulted on bonds or loans (for losses of $3.5 billion), and five have completed distressed exchanges. That constitutes the mildest outcome for defaults and related losses for the first five months of the year since 2011.

With outright yields on HY bonds in the range of 4.5% to 4.75%, it is to be expected that even if there is some further spread compression from here onwards, the risk of higher underlying yields **makes further gains for this market unlikely.** HY has gained 2.5% in the US and 3.2% in Europe year-to-date to the end of last week.

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