

THE BIG PICTURE OF GLOBAL ECONOMICS

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Inflation Taxing Bond Investors

- Bond market appears to be discarding the transitory narrative in favour of a high inflation outcome
 - Equities, nevertheless, appear to have an upper hand at the moment as they brush off growth concerns
 - News out of China has not been encouraging, where the property sector is facing potentially existential issues
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The fight continues between a bond market that has become more concerned about the outlook for inflation and an equity market that believes all will be well in the end. Strong US retail sales data ably supported last week's equity market rally. However, the bond market took fright from inflation data that shows US inflation hovering above 5% and global commodity price trends that are worrisome. Equities returned over 2% on the week, but short-dated bond yields rose nearly 10bps.

We would square the circle by seeing the strength in equities as a short-term reflection of the potential for growth to rebound and bonds as reflecting concerns about the outlook for the next 12 months. Good third-quarter corporate results, particularly in the financials sector, cheered up investors. Also, the news flow that economies are reopening their borders and framing COVID as an endemic is raising hopes for a rebound in growth forecasts through the balance of the year. As we write, disappointing Chinese GDP data may again hamper an easy ride higher in equities.

The bond market increasingly uncomfortable with the concept of 'transitory' inflation

While the core of opinion, led by the Fed, remains that the spike in inflation is transitory, investors in the bond market are increasingly doubtful. Instead of pricing in a moderating inflation scenario, the market is pricing in an upward shift in inflation that has not been seen in more than a decade.

Neither the US consumer price inflation (CPI) nor the producer price inflation (PPI) data last week carried any conclusive evidence of whether inflation is transitory or not. US CPI came in at 5.4% for September, broadly in line with expectations. The PPI was a shade lower than expected at 8.6%. However, inflation-linked bonds have seen breakeven rates surge. The 10Y US inflation bond is now pricing in a breakeven inflation rate of 2.56%, the highest since the Global Financial Crisis. The same idea is evident at the short end of the bond curve, where the 2Y breakeven rate has risen to 2.94%. The last time this measure was above 3% was in 2007. Both the 10Y and the 2Y were in negative territory in March 2020.

Chart 1: US 5 year breakeven inflation spikes



Source: Bloomberg

We see significant duration risk: The US 10Y yield has risen to 1.57%, up from the lows of 1.18%, but still lower than the 1.75% seen earlier this year. If we add the continued strength in commodities to the mix, the market appears to be discarding the "transitory" narrative in favour of a high-inflation outcome. Bond returns are negative for the last fortnight as yields have backed up, both in long maturities and at the short end of the curve.

A transition to "normal" would force yields higher, eventually. We suggest investors position accordingly. It is not necessary to believe that runaway inflation is around the corner to weigh on bond market returns for the rest of the year. The current – and final – quarter of this year and Q1 2022 will show whether the recent bout of inflation is merely a symptom of the resurgence of global demand or something more serious that can risk choking off the recovery.

Credit markets are still behaving. Except for emerging market credit, the credit market has been a solid source of earning for a better part of the period after the initial COVID crunch. How will things evolve from here?

Growth and liquidity keep credit risk in check, but interest rate risk is alive and well. The outright level of bond yields is so low that it provides very little insurance against even a modest rise in base yields from here. The US High Yield Master Index yields 4.15%; high-grade bonds pay 2.2% on average. We expect returns to remain flat to marginally negative in credit for the rest of the year, despite the markets being in exceptionally good health from a credit quality point of view.

Last week's economic data pointed to better news out of Asia ex-Japan. This is one part of the world where there is an increase in policymakers' acceptance of framing COVID as an endemic and hence allowing for a broader reopening of their economies.

Equity markets and sectors to buy for renewed equity market strength

With equities seemingly having an upper hand now vis-à-vis bonds, investors will be searching for value. Despite the tepid news out of China of late, **Asia ex-China** appears to be gaining momentum, which could lead to some good performance.

We believe that **Japanese equities** can benefit from reopening their economy even as the benefits of the recent political change kick in. Last week's release of Japan's Tankan survey showed strong momentum in the service sector.

Asia ex-Japan – Several countries appear increasingly comfortable with framing COVID as an endemic. This will allow more countries to reopen, providing much-needed momentum to economic growth after a long pause. Trade data in the region has improved. In Korea, the first ten days of trading for October was stronger than expected. The country added the largest number of new jobs in a month since March 2014. Economists note a marked pick-up in growth after the near-zero pace that we saw through July and August. Thailand announced that it will reopen for some vaccinated visitors from November 1st.

Chart 2: MSCI Asia ex Japan ex China A relative to Global equity index



Source: Bloomberg

Earlier-than-anticipated monetary tightening is the one risk to the good news in Asia. Last week the Monetary Authority of Singapore surprised the market when it tightened monetary policy slightly through its currency management, allowing the Singapore dollar to appreciate against the US dollar. The Bank of Korea indicated that it may increase interest rates as early as the first quarter of 2022. Economists expect interest rates to end the year at 1.5% compared with 2.75% currently. Prudent tightening may play out across Malaysia, Taiwan, and the Philippines, too. We wouldn't necessarily see this as negative. Instead, it should help ensure the relative stability of Asian currencies.

The metals and mining sector has had a sharp rebound in recent weeks, but we believe it has more substantial upside over the medium term. The ongoing greening of the economic activity will lead to a multi-year strong growth for many of the base materials. Current supply shortages are making up for concerns about weaker growth in China.

Evergrande fallout approaching a crucial juncture

To date, the fallout from the Evergrande meltdown has been confined to Chinese high yield bonds, where the property sector is facing some potentially existential issues. At least one other company has announced that it was skipping interest payments on its bonds. Unless all these firms find the cash to pay within 30 days, the creditors can declare an official default. That would leave the market in an even worse shape than now, with the yield on high-yield bonds rocketing into the distressed territory to levels not even reached during the COVID crunch. On Friday, the yield on Chinese high yield bonds came close to 25%.

Market consensus is for contagion to be muted, but the outcome not to be creditor friendly.

With losses of up to 80% of face value for some bonds already priced in, the expectation is for creditors to come up very short. However, the Chinese authorities have issued instructions for mortgages to start flowing again. Such measures might only provide short-term relief for developers desperately in need of operating cash. Still, it shows intent

hitherto not witnessed from the PBOC to begin to take concrete steps to ease the pressure. More is needed.

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