FEBRUARY 2018

THE INFLATION TANTRUM

The quick turnaround in US equities last night suggests that Monday's steep decline was probably just an inflation tantrum. Monday's correction appears to have been triggered by stronger than expected US jobs data and a jump in wages, prompting concerns that inflation is picking up and that interest rates will rise faster and further than anticipated.

In our 2018 outlook – "Charging Bulls, Crouching Bears", we acknowledged that resurgent inflation could be one of the "bears" that poses a market risk. Nonetheless we argued that the structural drivers of low inflation - globalisation, demographics and technological advancements remain intact. Our view remains unchanged. In fact inflation globally looks under control despite rising US concerns (Fig. 1).

Rather, the motivation for selling, seems to be the urge to take some cash off the table, following extended rallies.

In reality, the fundamentals that supported the rallies thus far remain intact.

The global manufacturing PMI, for example, has been on the rise since 2016; global growth is estimated to have grown by 3.7% in 2017, up from 3% in 2016. This broad based recovery looks set to continue with 2018 and 2019 forecasts revised to 3.9%.[1]

Strong corporate earnings have been another rally driver, especially since they have delivered ahead of expectations (Fig. 2). If this trend continues in the next few quarters, which seems likely if higher wages results in higher spending power, then equity markets seem likely to rebound – once the selling fervour abates.

Moreover, ongoing projected strong earnings growth allied with recent selling suggests that global valuations remain reasonable (Fig. 3)

Last but not least, liquidity growth continues despite the US Federal Reserve's tapering; with other central banks' talk of tapering yet to either materialise (e.g. the European Central Bank) or being dismissed (e.g. the Bank of Japan only recently indicated there was no change to its zero rate 10-year bond policy), liquidity should continue to support the financial markets.

Our suspicions are therefore rooted in that there was no "event" that seemingly justified the selling – other than some investors looking to bank profits or possibly reflecting nervousness at the low levels of volatility that the high liquidity has engendered.

There has also been a disparity between the manner in which investors have reacted. The rise in the Fed Funds 30-day Futures has been relatively gradual while the uptick on bonds yields also does not look out of line with the historical pricing (Fig. 4). Clearly, inflationary expectations are muted here.

All in all, Monday's selling has all the hallmarks of pricing risk into the market but with the underlying stories seemingly intact, similar bouts of volatility will be setting the ground for some attractive re-entry points in the future.

Fig 1. Inflation globally looks under control[2]

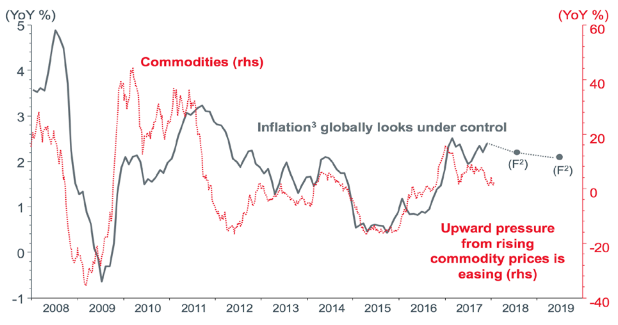


Fig 2. Earnings have delivered ahead of expectations[4]

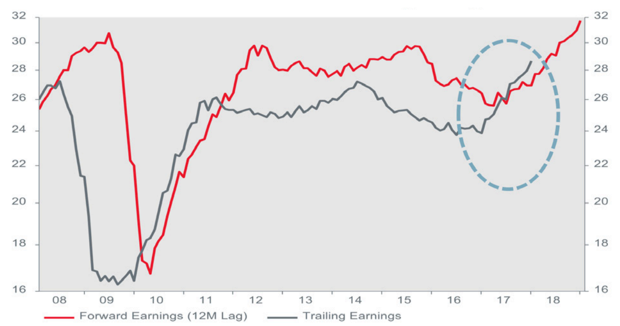


Fig 3. Valuations look reasonable[5]

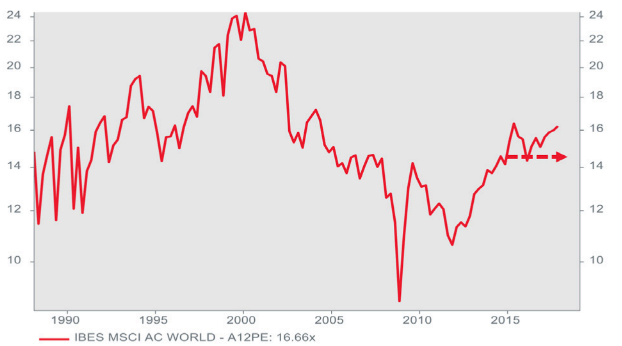
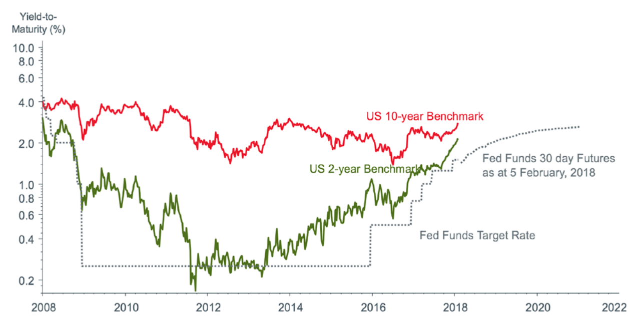


Fig 4. Recent inflation fears have not (yet) broken historical ceiling yields[6]



[1]International Monetary Fund, 22 January 2018. [2]2OECD, CRB Commodities and Oxford Economics from Datastream as at 1 February 2018. [3]As measured by the annual change in the Consumer Price index for the OECD. [4]MSCI AC World Forward vs Trailing Earnings from Thomson Reuters Datastream 6 February 2018. [5]MSCI AC World 12M Forward P/E from Thomson Reuters Datastream 6 February 2018. [6]Thomson Reuters Datastream US Benchmark bond indices as at 6 February 2018. Any opinion or forecast is subject to change without prior notice. Note that past performance is no indicator of present or future performance.

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