GLOBAL ECONOMY AND FINANCIAL MARKETS SHORT COMMENTARY

AMG 安柏 FINANCIAL GROUP

14 June, 2022

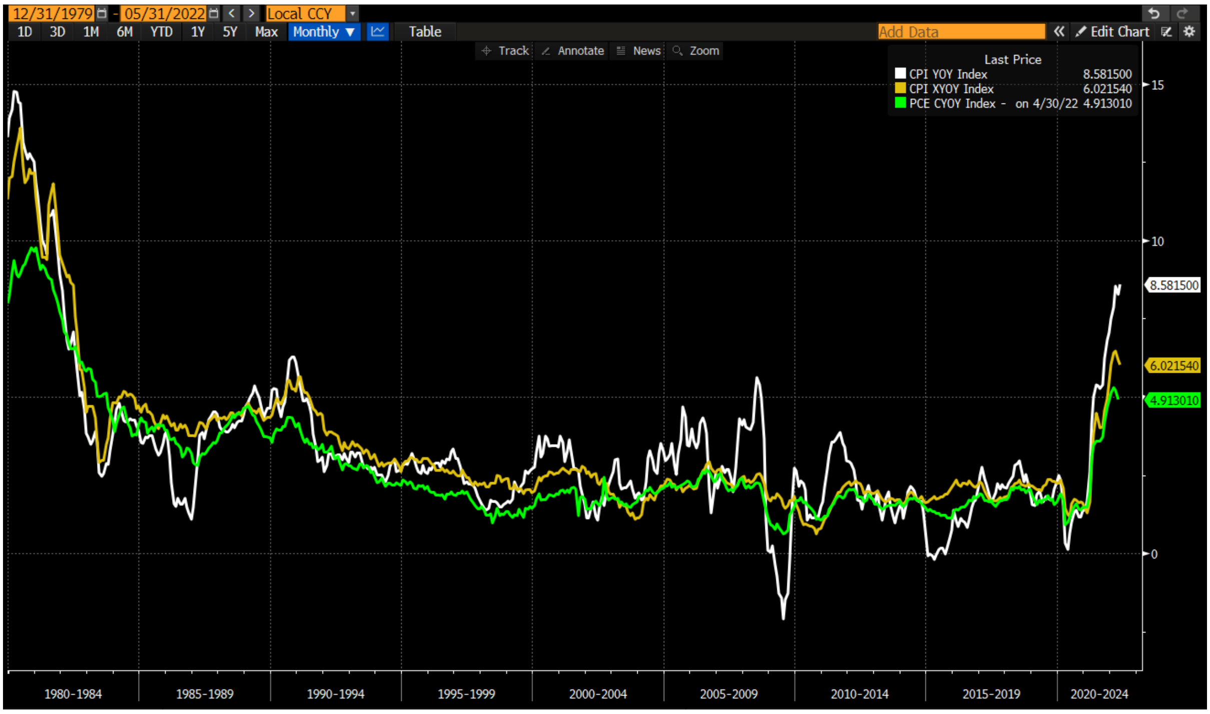
Inflation, Rate Hike Cycle and Their Implications

Investment markets have been rocked by the latest inflation figures from the US. Last Friday (June 10), the Bureau of Labor Statistics announced Consumer Price Index for the month of May has risen to new 40-year high, contrary to market expectations for a moderation in inflationary pressure.

The surprise prompted swift reaction from investors, dumping stocks and bonds across the board. For two days, the S&P 500 Index lost 6.68% (and sank the benchmark into bear market territory) while the tech-heavy Nasdaq Composite Index plunged more than 8 percent. The rout in bonds was no less severe, with the 10-year US Treasury yield jumping from 3.04% on last Thursday’s close (the day prior to data release) to 3.37% on this Monday’s close. Junk-graded corporate bonds fared even worse, with the Bloomberg US high yield corporate bond yield-to-worst soaring from 7.52% to 8.43% during the same period.

But is the May CPI figure really such a shocker? Let’s try to put it in some perspectives. Looking at the below chart, the latest monthly figure albeit set a new high since Dec-1981, it’s only higher than the March figure by less than 0.1% (8.58% vs 8.54%). And the miss against expectations wasn’t by a mile. Specifically, market consensus called for 8.3% or the same as the April figure, so the actual figure was higher by less than 0.3%. Meanwhile, we are bewildered that hardly any news mentioned about the core CPI (excluding the volatile food and energy components) actually fell for a second month in a row.

US Nominal CPI *(white line)*, Core CPI (ex. food and energy) *(yellow line)*, Personal Consumption Expenditures index (PCE) *(green line)*



Source: Bloomberg

This is not to downplay the seriousness of inflation, what with elevated energy prices and escalating crop prices hurting livelihood of regular people and eroding margins for broad range of companies operating in mid- to down-stream. Yet at the same time, investors should be cognizant of early signs of easing pressure from supply chains and logistics due to the COVID pandemic. In addition, more and more companies are preparing themselves to weather the coming period of slower economic growth and reviewing their human resources needs. Some companies have already started to freeze and even streamline employee headcounts. This should translate into moderating of wage costs further down the road.

Having said that, interest rates are set to go higher as real rates (i.e., nominal interest rate minus inflation) have overstayed at record low levels for far too long and central bankers have now admitted to the need to ratify the situation, and to do so without further delay. The following two charts show the real interest rates (green lines) in the US and EU. Noted that the chart for EU has a much shorter history due to the establishment of ECB only began in June of 1998. Nevertheless, it can be seen that prior to the Great Recession induced by the collapse of Lehman Brothers in 2008, real interest rates had stayed at positive territory most of the time. From 2008 and onwards, real interest rates have been largely stuck in negative territory.

US Core CPI YoY Change *(white line)*, Fed Funds Target Rate *(yellow line)*, real interest rate (i.e., Fed Funds rate minus core CPI) *(green line)*

Source: Bloomberg

EU CPI YoY Change *(white line)*, ECB Main Refinancing Operations Announcement Rate *(yellow line)*, real interest rate (i.e., ECB Main Refinancing rate minus CPI) *(green line)*

Source: Bloomberg

We would expect real interest rates to progressively move toward the breakeven level by means of central banks stepping up rate tightening and also through moderation of inflation looking in the months ahead. This would mean a sustained period of rate hike to ensure. Higher interest rates mean higher costs of borrow and also to service existing debt. For those companies that had borrowed extensively beyond their means in the past decade, the coming period will be highly challenging. To put it simply, the weakest companies may not be able to make it through the coming tightening period and will make room for the fittest companies to further prosper when this cycle ends.

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