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MAY COMMENTARY

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After a strong month for financial markets in April, conditions in May have been more volatile. Global equity benchmarks have been choppy and US equity indices are lower on the back of technology sector underperformance. US 10-year treasury yields have seen little change month to date at 1.64%, but have seen a low below 1.50% and a high above 1.70%. Gold has made gains of c. 6% month to date and the trade weighted Dollar index has fallen 1.5%.

On balance, economic data releases and business surveys continue to point to significant reopening momentum in the developed world, led by the US and UK. First quarter US GDP grew at an annualized rate of 6.4%, the second fastest quarter of growth since 2003. The alarming increase in COVID-19 cases in India and new infection waves elsewhere have not materially dampened the recovery in global activity or sentiment. The main source of volatility in recent weeks and has been inflation anxieties and shifting monetary policy expectations. A combination of unprecedented fiscal policy stimulus, accommodative monetary policy and economic reopening have pushed market implied average US inflation rate expectations over the next 5 years to 2.73%.

In late April President Biden announced the third fiscal stimulus package of his first 100 days in office. The American Families Plan proposes to spend $1.8tr on education and family support programmes which will be paid for in part by tax increases on higher income households. The most recent fiscal package together with the earlier American Rescue Plan and American Jobs Plan bring the total of new proposed fiscal spending to c. $6tr.

At its late April meeting, the US Federal Reserve (Fed) upgraded its outlook for the economy, lowered its assessment of risks, but surprised some investors with its unchanged policy guidance. The Fed was resolute in its commitment to asset purchases and near zero interest rates until further “substantial” progress is made toward its objectives of full employment and 2% average inflation. At the press conference following the meeting, Fed Chairman Jerome Powell was clear that the committee would act on actual data, not forecasts, and still viewed the rising inflation pressures as transitory.

Only days later former Fed Chair and now US Treasury Secretary, Janet Yellen, appeared to question this position, suggesting in an interview that interest rates may need to rise to avoid overheating the US economy. She later sought to clarify her remarks as neither a prediction nor recommendation, but it had already unnerved a market that is intensely focused on inflation and policy prospects.

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Ironically a big miss and disappointment in April's US labour market report calmed nerves of policy withdrawal. Only 266k non-farm jobs were added during April, well short of the c. 980k expected. Negative revisions were made to the March report and the unemployment rate edged up slightly higher to 6.1% due to an increasing participation rate. The disappoint in hiring seems at least partially due to enhanced unemployment benefits that have reduced the incentive for many to return to work until they expire later in the year. Following the report US 10-year yields briefly fell below 1.50%.

US Consumer price inflation climbed to a 13-year high in April, with year-on-year inflation moving up to 4.2% from the 2.6% recorded in March. Although strong base effects and supply constraints were expected to drive inflation higher in Q2/Q3 the latest figures were notably above the consensus of 3.6%. Details of the report suggest some of the strongest pressures will be transitory, with energy and used car prices rising 25% and 21% respectively over the past 12 months. Following the most recent inflation data, several Fed officials have reiterated their belief that inflation will recede, but this has only underpinned the concerns of some, that a delayed Fed policy response will allow inflation pressures to build. Following the inflation release the 10-year treasury yield climbed above 1.70%.

Although the probability of persistently elevated inflation has increased in recent months, our base case remains that inflation readings will start to normalise towards the end of the year as base effects pass, reopening demanding peaks and supply chain bottlenecks ease. We will closely watch for signs of stronger wage growth and/or further increases in longer term inflation expectations that could result in more sticky inflation pressures. That said, changes to asset allocation over recent months have prepared London & Capital client portfolios to be resilient under a scenario of more lasting inflation, by increasing equity and commodity exposure and focusing on shorter duration and higher beta fixed income.