

# Inflation reverberations



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The post-Covid inflation surge and accompanying jump in interest rates was a global phenomenon.

There were a few important exceptions, notably China and Japan, but almost all other economies experienced broad and sustained price increases, as well as higher interest rates. European countries such as Sweden and Switzerland abandoned negative interest rates, a dramatic reversal after years of sub-zero policies. Some emerging markets hiked early and aggressively, both in response to domestic inflation and to get ahead of the US Federal Reserve. American interest rates, after all, act as an irresistible gravitational force for global markets.



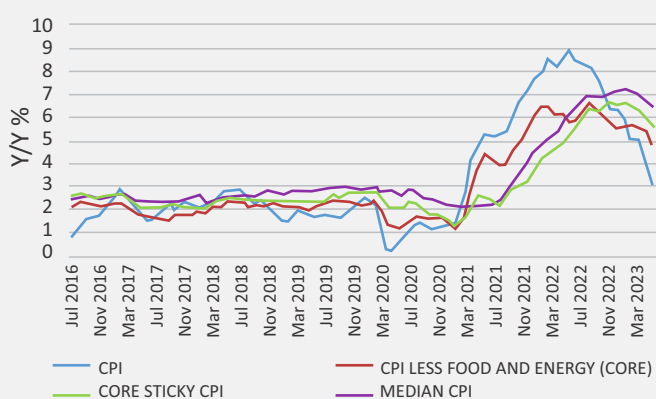
## Blurred lines

Today, the picture is a bit blurrier. Inflation seems to be moving in different directions across the world and with that, the policy stances of central banks. This has implications for investors.

Starting with the US, consumer inflation declined more than expected in June. This provided much cheer to markets, as it potentially reduces the need for substantial further interest rate increases.

The consumer price index rose 3.1% from a year ago in June, excluding fuel and food at 4.8%. These are the lowest inflation rates since 2021 and indicate ongoing progress towards the Fed's 2% target. Even some of the stickier items in the inflation basket seem to be coming unstuck.

Chart 1: US inflation measures, %



Source: Refinitiv Datastream

However, just as one swallow does not make a summer, one data release does not change everything. Investors and policymakers should consider a range of indicators to determine signal from noise. For instance, the CPI is not even the Fed's preferred inflation measure. Its favoured measure is produced by a different statistical agency from a different sample, the personal consumption expenditure (PCE) estimate. Some regional Federal Reserve banks also produce their own inflation measures, such as the Atlanta Fed's sticky inflation series, which isolates prices that don't move much, and the Cleveland Fed's median inflation rate, which tracks the item that is exactly in the middle of the inflation basket.

Then there is the fact that the US labour market continues to be fairly tight, with demand for workers

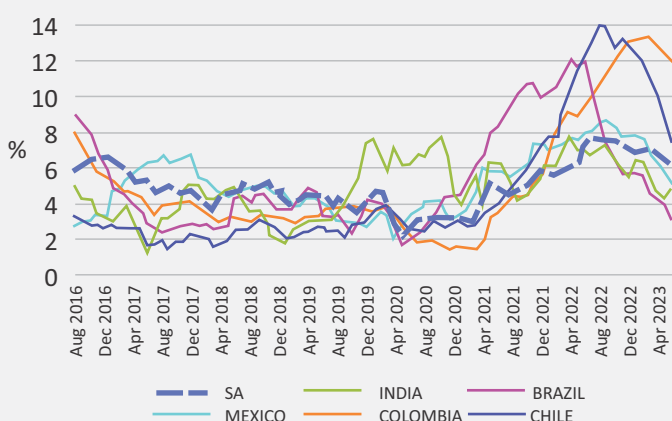
outstripping supply. This puts upward pressure on wages, which in turn means companies, especially service companies, will attempt to increase prices to protect margins. Whether they succeed, depends on what consumers are willing and able to absorb. Ironically, the decrease in inflation – and rising real wage – gives consumers more spending power and therefore the ability to pay more. This process is by no means automatic, but until the Fed has confidence that the labour market is sufficiently in balance, it is not going to be cutting rates simply because of one better than expected inflation print.

What most investors should care about are the extreme scenarios. The one is where inflation is so stubborn that the Fed is forced to hike much more than currently expected, another 100 basis points or so, which will really throw the cat among the market pigeons. Fortunately, this seems much less likely now.

The other extreme is where inflation declines rapidly and the labour market loosens up, allowing for rate cuts. Such a soft landing scenario should boost markets, though the recent equity market rally suggests some of this is priced in already. In the middle is the more likely path, where rates are near their peak but remain at these levels for some time until the Fed has enough confidence in its inflation outlook to pivot to rate cuts. The tricky part is that the higher for longer interest rates will build pressure on the economy and eventually force a slowdown. How bad things get for the economy and the associated earnings growth is obviously a source of uncertainty.

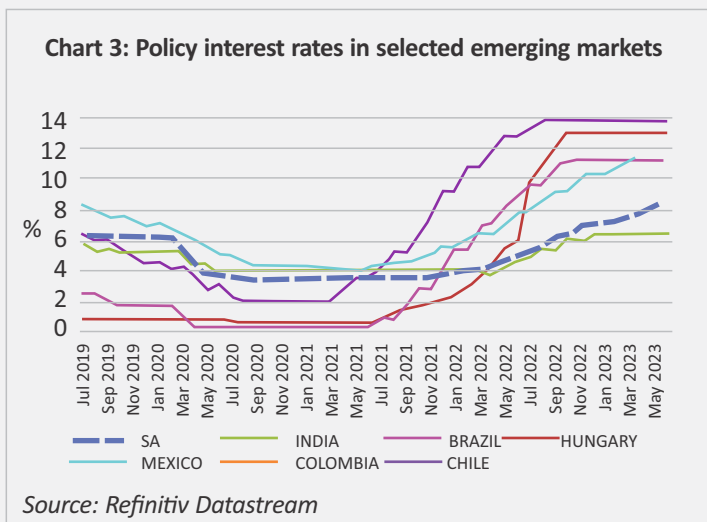
Some countries have made remarkable progress in taming inflation. Brazil's inflation rate is down to 3%, having peaked at 12%. Core inflation is still high at 6.6% but is falling rapidly. Brazil has a history of big inflation swings, including spells of hyperinflation in the 1980s and early 1990s that necessitated introducing a brand new currency five times between 1986 and 1994. Brazil's central bank knows that it is an inflation prone

Chart 2: Consumer inflation in selected emerging markets, %



Source: Refinitiv Datastream

economy and hiked aggressively to get ahead of the inflation problem starting early in 2022. It will be happy with the evolving outcome as the economy is seemingly not taking too much of a knock. However, we also don't know the counterfactual of how quickly inflation would have subsided on its own without central bank rate intervention. One could point to Turkey, where inflation peaked at 85% and the latest reading was 38%, but it is not exactly apples and apples.



Either way, the fact is that a bunch of emerging market central banks increased interest rates substantially in the face of big inflation spikes. Those spikes are now easing and the stage is set for reducing the very high interest rates somewhat.

South Africa is an outlier in this, unfortunately. Interest rates never went up as much and therefore the decline, when it comes, is unlikely to be substantial. In fact, the recent cycle is unusual in that local short term interest rates, long among the highest in the peer group, lagged.

Longer term interest rates – bond yields – remain elevated in South Africa, not so much because of expectations of what the Reserve Bank will do but because of concerns over government debt. South Africa's creaky fiscal outlook means there is a massive risk

premium built into our bond yields. Investors demand substantial compensation for the perceived risk of lending to the government.

### Deflation worries

And then there is the case of China. The latest inflation data was even worse than expected. In the rest of the world, this sentence would imply higher than expected inflation, resulting in additional rate increases. In China, it means the opposite. Inflation is too low. Prices fell in the month of June and were flat on a year on year basis. Excluding volatile items, core inflation was only 0.4%.

Deflation might seem great for consumers and no doubt some will be happy. However, it can be deadly in an indebted economy since the real debt burden increases. Moreover, if consumers postpone purchases because they expect lower prices in the future, it saps the economy of demand and dynamism. That is why monetary policymakers in the West fought tooth and nail against deflationary risks in the decade bookended by the Global Financial Crisis and Covid. In Japan, the fight has been going on much longer and, despite tentative signs of improvement, no one wants to declare victory just yet.

External demand is also not helping China much at the moment. Exports declined by 13% year on year in June, the fastest pace since the first days of the pandemic. Imports declined by 6%, a sign of soft domestic demand.

Hence the expectation of further, forceful stimulus measures. The People's Bank of China has only reduced interest rates a little and will probably cut them further as they are rising in real terms. However, rate cuts don't help much if there is no appetite to borrow. With confidence low and uncertainty high, especially around the future of the key property market, it would be a case of leading a horse to water without being able to make it drink.

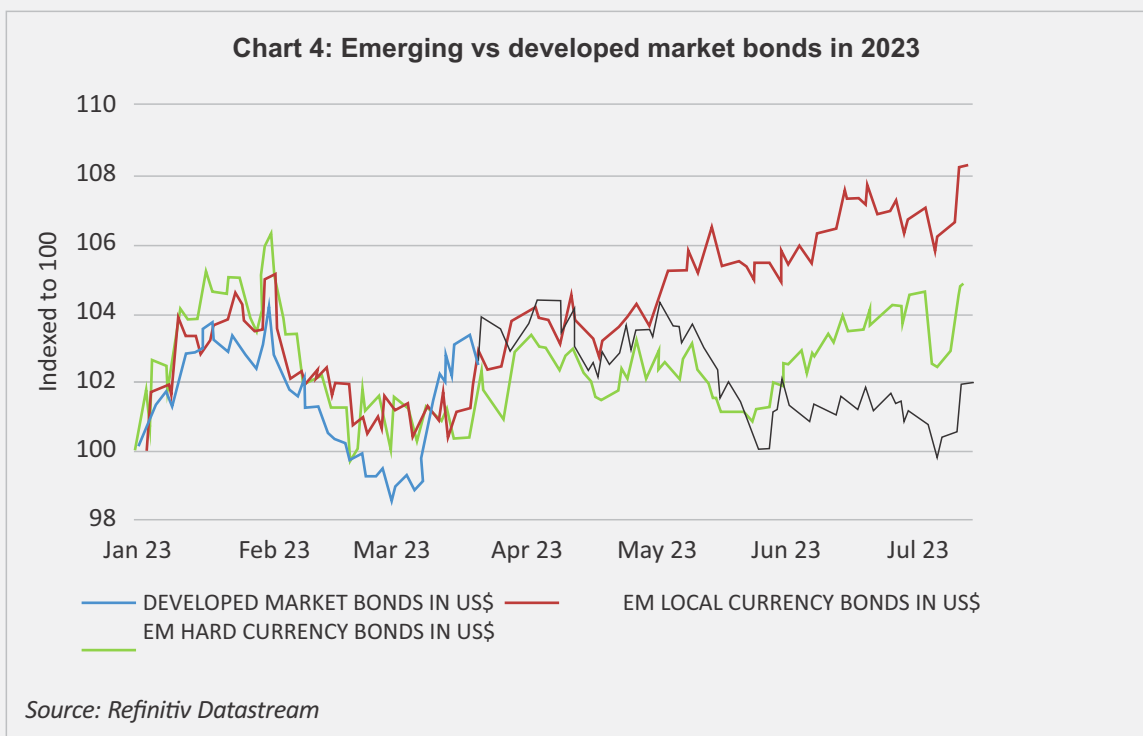
Monetary policy can become impotent when faced with an economy in balance sheet repair mode. This leaves fiscal policy. The central government has the capacity to borrow – there is ample domestic savings and the 10 year government bond yield is only 2.6% – but deciding where to spend the money is tricky. The usual playbook of juicing construction and infrastructure spending has delivered incrementally lower returns over time in an economy where there is much overcapacity. Giving money to households is the best option but one that has historically been resisted by Beijing.

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### Divergence

Back to the opening point about increased divergence between countries. What are the investment implications? I will highlight three. Firstly, currencies are very sensitive to expected changes in short term rates and the nearing end to the Fed's hiking cycle has seen the dollar pull back decisively against a range of other currencies recently. The dollar could get another leg down if Japan finally becomes the last country on earth to abandon negative interest rates. But we shouldn't get too excited about dollar weakness given that the US still has several structural and cyclical advantages over other developed countries.

Secondly, clearly investors in US equities are increasingly optimistic about a soft landing. The S&P500 has returned 16% year to date and is now a mere 6% below its previous peak. It is one of the most concentrated rallies in history, led by a handful of mega-cap technology shares, partly driven by excitement over breakthroughs in artificial intelligence (AI). The rally this year has also been driven almost entirely by multiple expansion, in other words, a rising price: earnings ratio. Earnings are still declining. The fact that this has occurred against the backdrop of rising, not falling, interest rates is reason for caution. Unlike most other global equity markets, the US is trading on the expensive side of its long term average. Other markets, such as in Europe, are cheaper but possibly further away from interest rate peaks.



Thirdly, there is a growing excitement about emerging market bonds, particularly local currency bonds. These have outperformed developed markets handsomely. In this grouping, Latin American bonds have been the big winners, with high yields and strengthening currencies. As mentioned, South Africa has not benefited much, partly because of our more muted rate cycle, and partly because of unique growth risks (loadshedding) and policy uncertainty. However, South Africa tends not to lag the peer group for too long. Eventually we should catch up, provided of course that the others don't catch down.

In summary, given that the worst case scenario for investors is one where inflation, particularly in the US, refuses to give way, the latest data is encouraging. But things are far from being back to normal, and the ride is still likely to be bumpy as the world slowly puts the pandemic and its reverberations behind it. Patience and appropriate diversification have served investors well over this uncertain period and should continue to do so in the future.