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Market sell-off: inflation and supply frictions should prove temporary

What's happened?

Global equity markets suffered a sell-off driven by fears of rising inflation, as the economic recovery from the coronavirus pandemic combines with growing concerns over bottlenecks and shortages in supply chains.

A number of companies have highlighted the potential negative impact of higher commodity prices on margins, as well as shortages of semiconductors. Technology and auto companies in particular have suggested that production in the second quarter (Q2) could be impacted, which could have a knock-on effect on inventory, higher prices and shortages of some consumer products. There are concerns that this could limit global GDP growth in Q2.

In the wake of the 0.8% increase in US consumer prices in April (4.2% year-on-year), higher commodity prices could prolong the period of above-trend inflation, with potential consequences for interest rate expectations.

Market impact

After a strong month for equities in April, the early part of May has seen a slight increase in volatility and some sizeable losses in stock market indices, in some cases coming off record highs. Over the last trading week[1] the tech-dominated NASDAQ US equity index registered a decline of 1.8% in US dollar terms, while some Asian bourses have also fallen. The moves have been dominated by declines in technology stocks, automakers and some sectors that are re-opening post-lockdown.

Bond markets have been relatively stable; yields on benchmark government bonds are lower than the highs they reached in early April. Break-even inflation rates have edged higher in recent weeks but are still consistent with inflation remaining close to central bank targets over the medium term.

1. Source: FactSet, data as of 11 May.

Chris Iggo, Chief Investment Officer, commented, saying that "the rise in commodity prices is consistent with a sharp recovery in global GDP growth and the ongoing outperformance of equities. However, there are frictions on the supply side and this is leading to significant commodity price increases which are unlikely to abate in the near term. Typically, commodity prices rise sharply as economies recover from recessions and given the support that has been provided through quantitative easing and fiscal stimulus there is currently a major imbalance between strong demand and inelastic supply of commodities across the industrial, energy and agricultural sectors.

Companies are trying to re-build inventories and investment spending is strong. In addition, government fiscal stimulus targeting infrastructure and green energy is adding to demand for commodities and materials needed for the energy transition. All of this is likely to persist for a couple of quarters until commodity supply can be increased and when the first flush of the global recovery has settled down. In the meantime, there will be concerns about inflation and rising yields. On the equity side, all eyes will be on production and distribution of materials and products to see how badly the supply chain has been impacted. Technology companies reported strong earnings in Q2 but expectations are being revised down in response to the potential manufacturing and distribution problems that are emerging as a result of the shortages of semiconductors."

What's next?

We believe that the macroeconomic cycle is in the early stages of recovery, so supply frictions are inevitable. We remain of the view that a long-term pick-up in inflation is not likely, as labour markets still have slack and global arbitrage in goods and services will limit bottleneck-driven long-term inflation gains.

Monetary policy changes are not expected in the short term although markets will be focussed on the tapering of asset purchases in some economies from early next year. Rates should remain low and bond yields likely capped given the ongoing strong demand for long-dated, high-quality fixed income assets. The macro cyclical position continues to suggest being overweight equities and credit, but returns are likely to be subject to more uncertainty given the frictions in the re-opening of the global economy.