May 17, 2021

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Weekly Macro & Markets View

Highlights and View

- **US headline inflation jumps to the highest since 2008, reaching 4.2% YoY in April**

  Strong demand is facing supply bottlenecks and base effects that are pushing up inflation rates, though most of the rise is expected to be transitory.

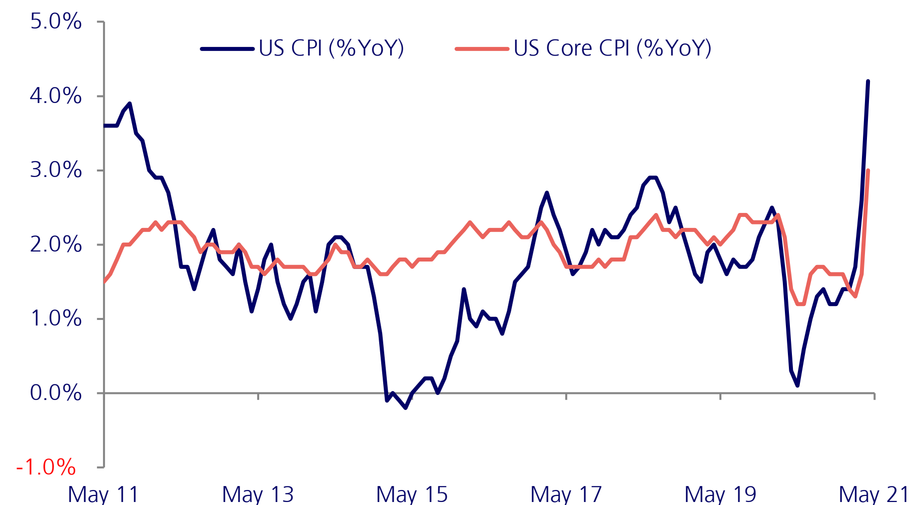
- **Equity markets stumble and bond yields are driven higher as inflation takes centre stage**

  While we had anticipated a correction for stocks, the pullback was short-lived as Fed officials soothed investors' policy fears. We suspect that volatility will persist as inflation fears linger.

- **Corporate bond markets barely reacted to volatility in stocks with spreads remaining at YTD tights**

  The resilience of corporate bond markets in the face of several recent stock market corrections is evidence of the robust supply/demand technicals that are likely to persist for some time.

US inflation soars as base effects kick in



Source: Bloomberg

US inflation rates accelerated significantly in April with the headline CPI number reaching 4.2% YoY, the highest since 2008, while core CPI jumped to 3.0% YoY from 1.6% the month before. Strong demand meeting partially constrained supply chains led to strong price increases in several sectors while base effects distort the annual comparison. A substantial amount of the increase in prices represents transitory pressures caused by short-term bottlenecks and the reopening of the economy, reflected in rising prices for used cars, lodging, airfares and food away from home. The labour market is showing more signs of healing. For the third month in a row the NFIB's 'jobs hard to fill' component reached a record high, indicating that many firms are still struggling to find enough employees to fill open positions. The strength of the labour market can be confirmed by other indicators, as well. The number of open positions in March soared to the highest on record according to the Bureau of Labor Statistics. Meanwhile, consumer-related data were on the weaker side last week. Retail sales were flat in April, following the jump in March fuelled by the stimulus checks. Finally, the University of Michigan's survey shows that consumer sentiment deteriorated in May, driven both by the current situation as well as expectations, which were weighed down by higher inflation expectations.

Markets: A flash correction for stocks, while bond yields rise

The first turbulent week for investors in a while saw stocks plunge in the opening few days and bond yields rise on inflation fears. This was particularly notable in the US, with the tech-heavy Nasdaq index giving up more than 5% by Wednesday and the VIX volatility measure jumping to a two-month high. Other regions, notably China, fared better, but the smooth up-track for stocks was tested before confidence returned as several Fed speakers expressed commitment to an unchanged policy for the foreseeable future. Though last week's correction appears to have been short-lived, with the S&P 500 bouncing off support levels, there may still be downside risk in the near term as inflation fears are likely to persist for some time. Indeed, bond markets are again under pressure. While US 10yr yields retested the 1.7% level last week before easing back, it was European yields that caught the eye. German and UK yields hit two-year highs, helped by improving growth forecasts, while peripheral spreads widened modestly. The growth/inflation dynamic will likely define market moves in the months ahead.

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Credit: Bonds remain rock solid despite stock market jitters

Corporate bond markets were solid as a rock amid the inflation concern driven volatility that hit stocks and other assets last week. Indeed, spreads of investment grade credit indices of both the US and Europe barely budged from the year-to-date tights, while in high yield they were modestly wider. Primary markets continued to remain active with US high yield supply already setting a H1 record, while investment grade credit supply was robust, helped by a jumbo deal from Amazon. Despite softer sentiment in other risk assets, newly printed bonds traded well and attracted strong demand. CDS spreads have been underperforming cash markets, and this will likely continue as weaker technicals in this market entice macro players to use CDS as a cheap hedging tool. ESG issuance has been robust recently with supply from both corporates and governments, such as Germany last week, seeing strong demand. We think the resilience of cash credit despite tight spreads is a testament to strong demand/supply technicals that should remain in place for some time.

China: Retail sales are lacklustre, exports remain the driving force

It is not worth digging too deeply into China's economic statistics for April due to various distortions. The base effect due to COVID-19 last year and issues in analysing the sequential data following Lunar New Year in Q1 are comparable to foggy weather conditions. However, there are some visible core trends. Economic activity has slowed in some segments of the domestic economy. With the exception of online sales, service sector activity and retail sales are slowing. Industrial production is benefitting from the still vivid export sector, but supply chain disruptions are taking their toll. Fixed asset investment remains solid for manufacturing and the property sector, although we note that property starts as a leading indicator are weaker than property sales. Infrastructure investment growth is slowing, but still solid. Intense regulatory tightening so far this year is also visible in slower credit growth, though liquidity conditions should remain stable before the Communist Party's centenary celebrations in early July. The PBoC is expected to look through the recent surge in producer price inflation.

Australia: The extra budget allows the government to spend more on the economy

The government lowered its fiscal deficit estimate from 9.9% to 7.8% of GDP for 2020-2021. The swift economic recovery, and notably the vigour of iron ore exports, helped lift fiscal revenue and fiscal savings. The budget windfall for the next five years is expected to be around AUD 104bn in total, equivalent to about 5% of GDP. Encouragingly, most of this amount will be put back into the economy. Additional fiscal stimulus measures mainly include infrastructure spending, care for the elderly, and housing incentives. It is a fundamental shift in the government's thinking concerning fiscal positions, moving from a conservative stance pre-COVID to a more open mind in terms of public spending to support long-term growth and employment. We think this was the reasonable move given that Australia's net public debt is quite modest at less than 50% of GDP and interest rates are still low by historical standards despite rising bond yields.

LatAm: Economic activity continues to recover with less dovish central banks

In Brazil, the pandemic situation has improved while vaccination has accelerated, generating a better outlook for H2. Economic activity contracted 1.59% MoM in March, less than the -3.4% MoM expected by the market. Inflation continued to accelerate, reaching 6.76% YoY in April. Chile and Mexico maintained their monetary policy rates at 0.5% and 4% respectively, with less dovish statements. In Chile, the statement signalled that the economic outlook has improved, which would imply that the downside risks to inflation have diminished. However, it was pointed out that the convergence of inflation to the target requires that the monetary stimulus remain highly expansionary. In Mexico, the statement indicates that the inflation balance has tilted upward. However, inflation is expected to converge to 3% in 2022. Finally, the results of the election of constituent assembly members to draft the new constitution in Chile show that the government coalition obtained a lower vote than expected. In contrast, unorthodox left independents got a higher vote than expected.

What to Watch

- The G3 PMIs will reveal if the services sector is now taking over from manufacturing as the main driver of growth.
- In the US, housing data are expected to reflect a stabilisation while investors will focus on the latest Fed minutes for any hints about the future path of monetary policy.
- In APAC, Japan's Q1 GDP data as well as April foreign trade and CPI data will be the main focus. Australia's retail sales are expected to show further upside in April while employment data should confirm how well the labour market is holding up on the back of fiscal tapering. PMIs and consumer confidence data for May also need to be watched. Thailand's and Indonesia's export data as well as Taiwan's export orders are likely to have been robust in April, partly due to base effects.
- In Chile, Q1 GDP will be published, which, although it will be affected by the pandemic, should show that the economic recovery continues. Argentina will post economic activity for March.

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