June 14, 2021

Weekly Macro & Markets View

Highlights and View

- **US inflation accelerates as strong demand meets bottlenecks and base effects distort comparisons**

  Similar to last month, transitory components make up a large part of the rise, though some elements like shelter costs could reflect more sustainable price increases.

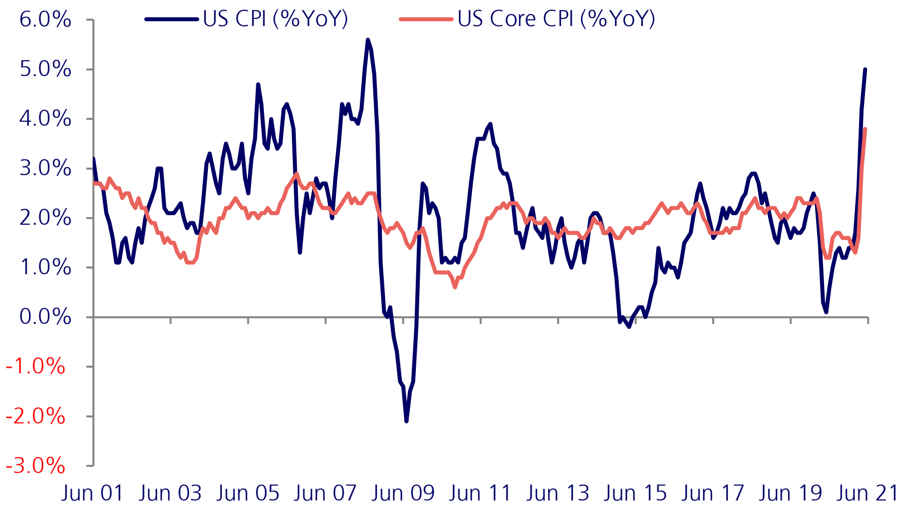
- **Global bond yields slump despite strong inflation data, likely reflecting more dovish policy expectations**

  The move down in yields appears overdone given a still relatively early economic cycle, strong inflation data and a brisk growth outlook.

- **Energy retains its top performance slot in credit, supported by oil prices and rating trends**

  While inflation worries dominate the broader markets, credit profiles of commodity credit sectors have notably improved, although tight spreads have now largely priced in improvements.

US Core CPI soars to the highest in almost three decades



Source: Bloomberg

Headline inflation accelerated to an annual rate of 5% in May, the highest level since 2008. Energy prices, currently almost 28% higher than a year ago, are a big driver of the annual comparison. Prices have been flat on a monthly basis, however, indicating that the impact of energy may fade in the coming months. Core inflation rose to the highest level in almost three decades, reaching an annual growth rate of 3.8%. Similar to last month, transitory components that are linked to the reopening of the economy like car and truck rental, airfares and food away from home were responsible for a large part of the price increases. There are some elements in the latest set of inflation data that could reflect more sustainable price increases, particularly shelter costs and owners' equivalent rent. These make up a substantial part of core inflation and are likely to rise further in the future as strong job gains and wage increases, particularly among lower income households, are likely to drive rents higher. Job openings reached a record high in April and firms keep struggling to fill open positions, which is one reason why small business optimism ticked down in May. Finally, the University of Michigan's consumer sentiment survey shows that households became slightly more confident regarding both the current situation as well as the outlook.

Global Bonds: Yields slump despite inflation surprising strongly to the upside

Global bond yields slumped last week, with the 10yr Treasury yield closing below 1.50% for the first time since March. With inflation surprising strongly on the upside, this is unlikely to reflect a reassessment of inflation risk, but instead more dovish policy expectations. Indeed, longer-term inflation expectations have been relatively steady, trading within a narrow range. One catalyst for the slump in yields was the prior week's US payrolls data, which disappointed again, causing a reassessment of Fed's tapering decision. Other US labour market indicators are very strong though, and the Fed will put some weight on these too in its policy decision. Elsewhere, the ECB confirmed that the faster pace of PEPP purchases will continue. This was in line with expectations and, as growth should accelerate in H2 and headline inflation is firm, the fall in Bund yields looks overdone. While we suspect that yields will rebound, recent moves show how decisive the policy outlook is, and spells of higher volatility should be expected as we move forward towards the first steps of policy normalisation.

Eurozone: The ECB confirms extension of higher pace of PEPP into Q3

As expected, at its regular monetary policy meeting and press conference the ECB said it would extend its policy of a higher pace of asset purchases under the Pandemic Emergency Purchase Programme (PEPP). Whilst recognising the economic environment has improved, ECB President Christine Lagarde said that it was still necessary to keep monetary policy loose in order to preserve favourable financing conditions. The challenge for the ECB will probably come later in the year when it will likely need to adjust its communication to indicate a slower pace of asset purchases without creating too much volatility in financial markets. Meanwhile, data released last week showed that the contraction in the Eurozone during Q1 was less bad than initially thought, with GDP falling just -0.3%QoQ compared to an initial estimate of -0.6%QoQ. However, the revision was mainly because of extremely volatile data from Ireland. More importantly, forward-looking indicators, such as the ZEW survey released last week, are consistent with a strong improvement in the Eurozone economy the rest of this year.

Japan: Manufacturing sector trumps services

Japan's GDP for Q1 was revised up to an annualised sequential rate of -3.9% (-1.6% YoY) as public spending fell less than previously reported. Looking forward, we note a common tendency in both the quarterly Business Survey for Q2 and the Eco Watchers Survey for May: the outlook for the manufacturing sector remains promising, while the services sector continues to suffer from the negative impact of the state-of-emergency for major prefectures. However, the outlook component for the latter is recovering markedly, probably incorporating the recent fall of new infection cases and the speed of vaccinations. Though lagging other G7 countries, 12.6% of Japan's population have received their first inoculation, improving the outlook for domestic consumption. Meanwhile, machine tool orders for May confirm strength in Japan's machinery sector, mainly driven by foreign orders. Finally, while Japan is the only major country showing disinflationary trends, with its CPI still in negative territory, some upside price pressure is visible in producer price and wage data for May. Both came in stronger than expected.

China: Credit impulse contracts, while PPI inflation surges

China's aggregate financing increased in May from April, but we prefer to focus on the year-on-year performance due to seasonality. In YoY terms, growth slowed to 11% from 11.7%, with the credit impulse falling into negative territory, driven by contracting shadow banking activities as well as lower corporate and government bond issuance. We note that authorities have kept a tightening stance towards the housing market, while long-term corporate loans continue to rise. Producer price inflation rose to 9% YoY, a 13-year high, mainly due to surging raw material prices, while core consumer price rises remained contained at 0.9%. We believe the PBoC will look through the latest surge in producer prices and keep monetary policy stable. Meanwhile, export growth, though solid, seems to be rolling over, not least due to the impact of supply constraints. On the credit front, regulators have asked major banks to stress-test exposure to Evergrande, which raised eyebrows in the credit space and concerns that government backed bailouts should not be taken as a given.

Credit: Energy shines while issuance usage ranges from ESG to Bitcoin

Credit markets remained strong last week with robust investor demand seen in both secondary and primary markets. Spreads tightened across sectors, geographies and products, with the US high yield energy sector remaining the best performer. Commodity related sectors and especially the energy sector credit profiles have benefited from higher prices, although these have led to inflation concerns more broadly. New supply remained robust while the asset class continued to receive inflows, especially in investment grade. ESG issuance from the European utility sector remained strong and it seems that the share of ESG financing in the primary market should continue to rise. At the same time, a debut high-yield issuer in the US reportedly issued bonds to fund bitcoin purchases, with the bond receiving strong demand from investors. Credit market fundamentals continue to improve, with rating trends positive and default rates trending downwards. All in all, while momentum in credit continues to be strong, spreads are now tight, and some pockets of froth are emerging.

What to Watch

- In the US, investors will focus on the Fed meeting, looking for clues regarding the beginning of the tapering process, while retail sales will shed some light on current consumer spending.
- Industrial production and inflation data will be released in the Eurozone while the US and EU hold a summit meeting. Separately, progress on the Next Generation EU initiative will be discussed at the Eurogroup/Ecofin meeting.
- In APAC, we expect the central banks of Japan, Taiwan and Indonesia to keep policy rates unchanged. The anticipated May data are: Industrial production, fixed asset investments and retail sales in China; export data in Japan, Indonesia and Singapore; and labour market data along with Q1 house prices in Australia. On Monday, markets are closed in China, Hong Kong, Taiwan and Australia for holidays.
- In Brazil, we expect the central bank to continue with the tightening cycle, increasing the Selic rate by another 75bp, while economic activity should continue to recover in April.

Zurich Insurance Company Ltd
Investment Management
Mythenquai 2
8002 Zurich

173001566 (01/16) TCL

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