

**Inflation – Is It Time to Panic? – Market Commentary – May 2022**

Global markets were relatively flat in May, with somewhat positive inflation data in the US. This is in contrast to the movements seen to date in June on which this commentary is focused. From a year-to-date perspective we note the JSE’s flat/superior outperformance at 2.1% in USD terms relative to Emerging Markets which are down -11.8%. We also note the steep underperformance of the MSCI Growth Index vs the MSCI Value Index -22.2% vs -3.6%. Note that the Value index includes Oil, which has been strongly positive. We also note the underperformance of the Nasdaq relative to the S&P 500 -22.3% vs -12.9%, both down for the year-to-date.

**Table 1. South African and global equity returns (USD) for May 2022\***

	May-22	YTD 2022
FTSE/JSE ALSI (ZAR)	-0.4%	-0.3%
FTSE/JSE ALSI (USD)	1.1%	2.1%
MSCI World	0.1%	-13.0%
MSCI EM	0.4%	-11.8%
MSCI Value	2.1%	-3.6%
MSCI Growth	-2.3%	-22.2%
S&P 500	0.1%	-12.9%
Nasdaq 100	-1.5%	-22.3%

\*Total return indices, Source: Factset

June 10 saw the release of May inflation data for the US. In response to the 8.51% (source: St Louis Fed) number the S&P 500 declined -6.68% over the following 2 days. The US 30-year Treasury yield climbed from 3.17% to 3.43%.

**Why the declines?**

The markets were obviously concerned with the lack of decline in inflation and the implications for interest rates and asset prices i.e. implied higher interest rates and downward pressure on asset prices.

**Were the declines justified?**

We do not necessarily assume so. The longer term inflation data is set out in Chart 1 below for both CPI and Core CPI.

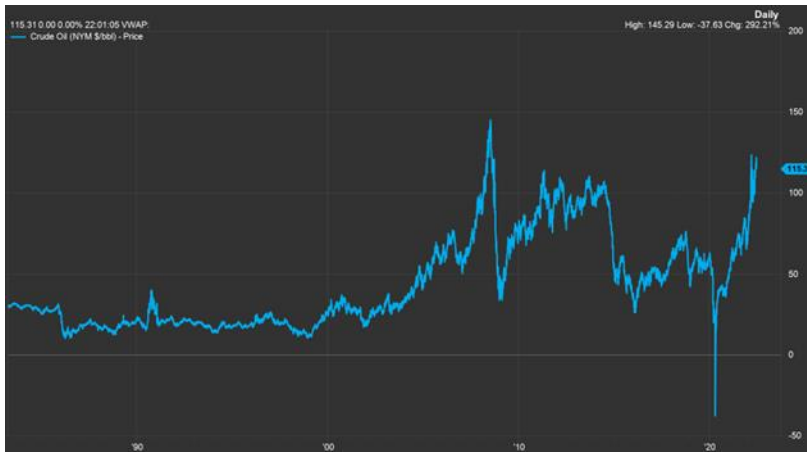
**Chart 1. US CPI and Core CPI year-on-year percentage movement**



Source: Factset

The market appeared to be looking for immediate gratification i.e. a decline in inflation. Instead, inflation, as measured by CPI, was merely stable. This should be hardly surprising, however. The price of oil, illustrated in Chart 2 below, has risen by 73% in the previous 12 months. Oil makes up approximately 7.5% of the US inflation basket i.e. this is its direct contribution. As is well-known it has indirect effects throughout the economy as well. Oil itself has been somewhat stable pushing against the \$120 mark.

### Chart 2. Oil price (WTI)



Source: Factset

At approximately 7.5% of the inflation basket, a 73% increase in the price of Oil suggests the remaining items in the basket should have moderated significantly. This is where Core CPI comes in.

### What about Core CPI?

Core CPI measures the increase in the basket excluding energy and food. Significantly, this is declining - at 6.01% it is the second consecutive lower monthly reading.

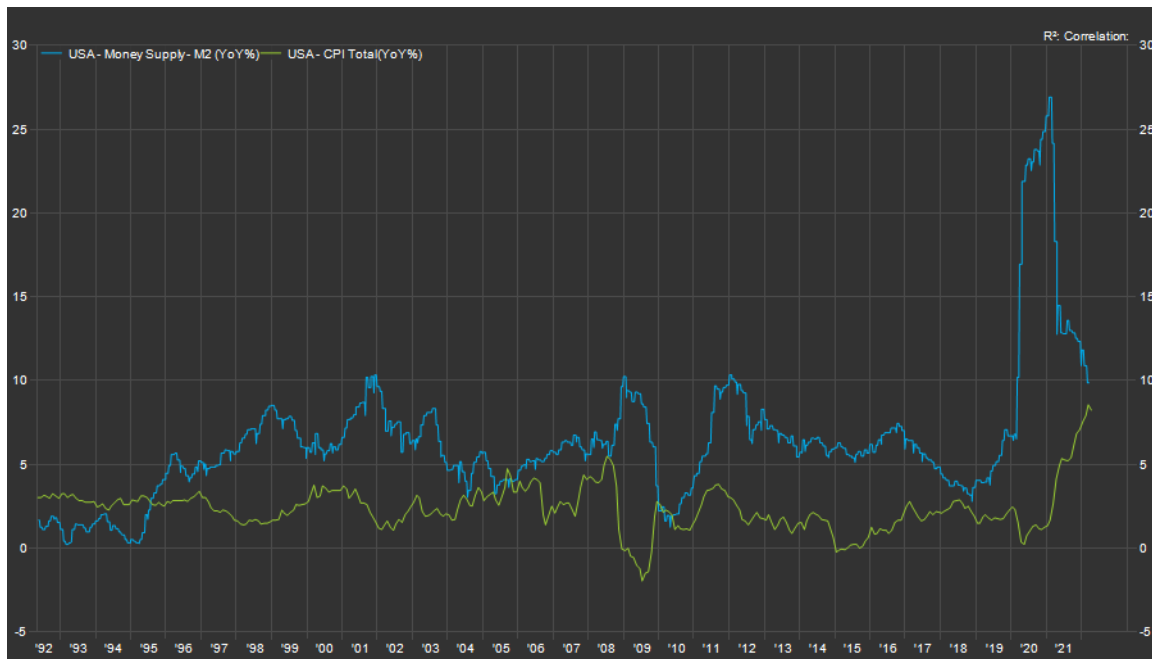
### Where to for inflation?

The declining Core CPI and the more stable CPI suggest Oil and Food have continued to increase and are the main problem. So what to do about these?

The Fed's preferred inflation measure is Core PCE (Personal Consumption Expenditure). Core inflation is less volatile. Also, in the words of the Fed's Chair during the press conference following the release of the June data, "Oil and Food we can do nothing about, so we don't include them". This begs an obvious question - if the Fed cannot do anything about Oil and Food why raise the interest rate in response? Monetary policy appears to be a crude tool for a supply shock - why restrain demand in the economy in response to an increase in input cost? Incidentally the South African Reserve Bank has historically followed a very similar practice in its response to fuel price increases.

In last month's commentary we suggested that the primary reason for the global inflation we are seeing today is the US monetary response to the Covid crisis. With money supply declining from a close to 30% annual growth rate to below 10% today (set out again in Chart 3 below), everything else being equal we expect inflation to moderate in response.

### Chart 3. US money supply growth vs inflation



Source: Factset

Everything else is not equal, however. We have a war in Ukraine. While the initial commodity price increases in 2020 and 2021 are related to increases in US money supply, the latest movements since March i.e. the most recent 27% price increase, is in direct response to the Ukraine conflict.

A humble suggestion for resolving the inflation problem therefore is to resolve the Ukraine conflict. Russia produces close to 11m barrels of oil per day. Total global production is below 80m barrels per day. Excluding Russian supply is neither practical nor possible in our view, irrespective of what the media tells us, and sanctions clearly carry steep costs for both sides.

For inflation to increase further the oil price would need to repeat its performance to date. For the 11 months from 30 June 2021 to 31 May 2022 the increase is 55% vs the 73% for the 12-month period i.e. already a lower rate of increase, unless it rises further again in June. The same inflation effects feeding through again over the next 12 months would require a price of \$200 a barrel. This is not impossible. We note, however, that the same predictions were being made in 2008 when oil reached \$147. We also feel economies, primarily the US economy, have little tolerance for further oil price increases.

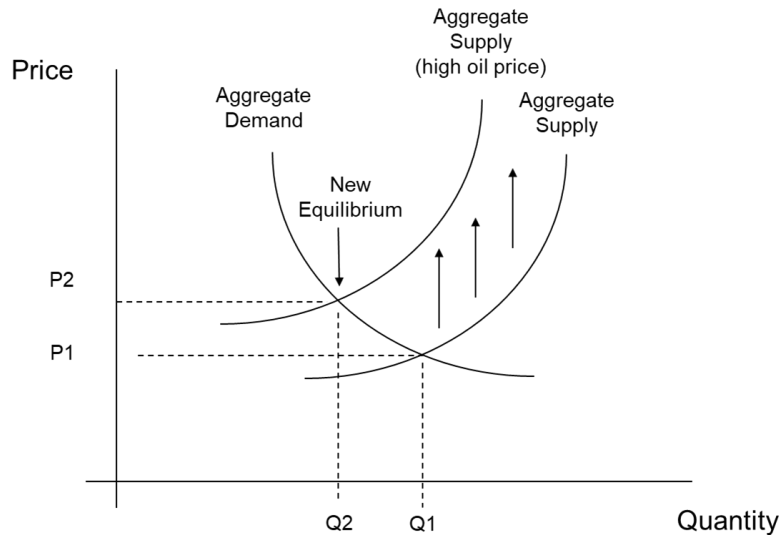
Another comment on Chair Powell – at the same press conference he noted how inflation was not a problem just in the US but globally. This is true but strikes us as disingenuous. Inflation is exported through trade flows, and oil prices are denominated in USD. The primary global inflation driver has been the US as the largest economy.

### **What about growth?**

In 2008 amidst failing banks were lone economic voices suggesting the recession then was caused less by the banking crisis (we doubt this) and more by the high price of oil (we believe this to be an important contributing factor). How does a high oil price cause recession? Consider simplistically Chart 4 below. A higher oil price raises the cost of aggregate supply at every quantity leading to new equilibrium at a higher price level and a lower level of output, hence the talk of stagflation. We would add to this that raising

interest rates constrains aggregate demand, pushing the demand curve further left, averting inflation but settling at a yet lower rate of output i.e. worsening a recession.

**Chart 4. Impact of high oil prices**



**What is the impact on stock prices?**

The environment feels very similar to 2007/8. While some commentators suggest the difference this time is there is inflation, the reality is there was inflation then too – consider Chart 1 again – inflation went up close to 6% before declining rapidly. Should high oil prices and high interest rates cause a recession we can expect oil and other commodity prices to experience sharp declines again (still allowing for restricted supply in the case of oil). Stock prices would likely decline, especially commodity stocks. It is possible the market is already at least partially discounting this scenario.

**What about interest rates?**

Should inflation peak at its current levels long Treasury yields can be expected to decline which would be supportive of equity prices. If a recession materialises, Treasury yields will also likely decline. Since a recession affects the profit side of the equation too this would be negative for stock prices. Again, some of this may already be discounted in market movements to date.

Either way our view is Treasury yields will likely decline, rising only if commodity prices continue to rise. While not impossible we view this latter scenario as unlikely, not least because as mentioned already we feel the large economies have limited tolerance for further increases.

**Summary**

In summary, it is possible inflation is peaking. If this is true, likely so are Treasury yields. A question mark remains over the possibility of recession. In our view the possibility of this is high. While much of the market has already declined, we may still witness declines in commodity prices and commodity stocks.