INVESTMENT STRATEGY
WEEKLY VIEW

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# THESE HIGHER INFLATION NUMBERS TOO SHALL PASS

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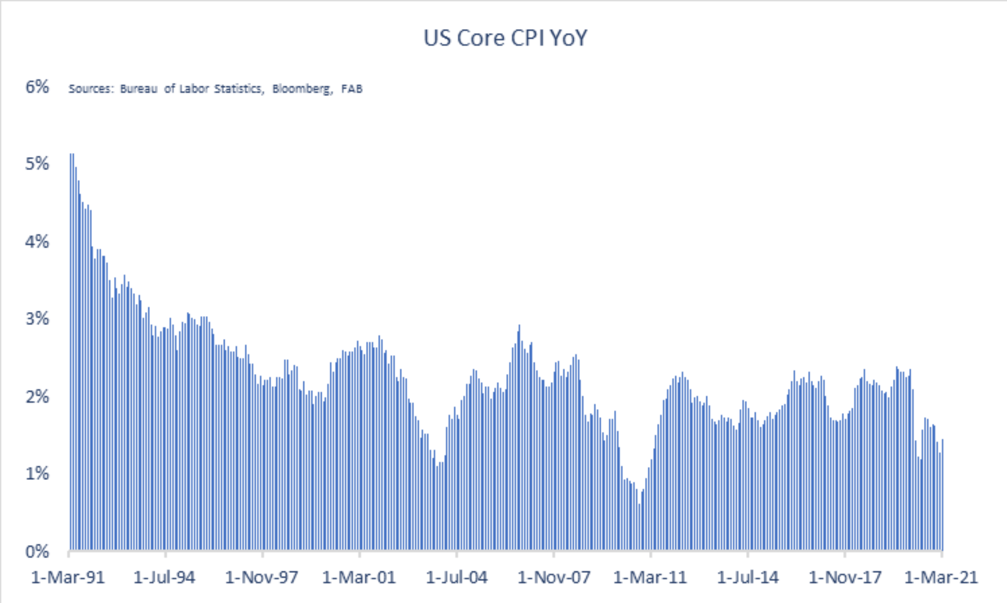
- This week could see more elevated inflation data from the US, after the producer price index last week came at 4.2%, the highest since 2011.
- US economic data is generally expected to be strong and further supports a 'risk-on' stance.
- The S&P 500, for one, is already up 9.9% year-to-date.
- The FAB AAC is overweight in equities, IG and EM bonds and gold, and is underweight in alternatives.




Inflation used to be the bogeyman, but for the past decade it has been elusive. No matter how much the European Central Bank, the Bank of Japan or the Federal Reserve try, they just cannot seem to get prices moving up steadily. It may sound counterintuitive that they would even want that, but a little bit of inflation is a sign of economic health. It also helps manage the debt of countries and companies.

For the first time in a while, the headline inflation rate is looking up. On Friday, the US Bureau of Labor Statistics reported the Producer Price Index, which measures how much companies pay for the raw materials to produce finished goods. The most watched element of these, final demand PPI, rose 4.2% compared to March, 2020, higher than the 3.8% median forecast of economists surveyed by Bloomberg, and the highest print since 2011.

Treasury yields rose across the curve on Friday with the release of the PPI number. The 10-year US Treasury yield rose 4 basis points on Friday. The measure had been in retreat for most of the week as the new quarter started with heavy buying of bonds, which some analysts had suggested were becoming relatively cheap. The 1.66% 10-year yield on Friday was still 6 basis points lower than where it closed a week earlier.

This week is likely to bring another inflation 'sticker shock' and, with it, perhaps also higher Treasury yields. The median forecast among economists surveyed by Bloomberg expects the broader consumer price inflation index to have risen 2.5% last month over March of last year. That is higher than the 2% stated target of the Federal Reserve.

## Core CPI, the one watched by the Fed, has trended down over the past three decades

The Fed, however, does not target 2% for the broad CPI, which is highly volatile. The number refers to so-called 'core CPI', which excludes food and energy prices. That figure is expected to come in at 1.5%, hence still short of the Fed's goal.

The core CPI, however, is on the rise and when compared to the deflated index of the second quarter of 2020 it could start looking quite high. If core CPI numbers return to their long-term trend, the year-on-year number could reach 2.2% in June.

Just the creeping approach towards that figure could spur some speculative activity in inflation hedges and benchmark bonds such as the 10-year US Treasury. Normally, the yield on the 10-year US Treasury tends to be higher than the core CPI, though that relationship has been upended in the zero-interest -rate environment and it has not held for the past 20 months.

Still, the inflation doomsayers could have a moment of vindication in the coming months and that could open an interesting opportunity for savvy investors to add both good quality bonds and high growth stocks to their portfolios before inflation goes back to its long-term trend.

After all, core inflation has trended steadily down over the past 30 years, as technology reduced many of the costs of production as well as the number of intermediaries for every transaction. Globalization has also reduced the cost of labour for production, as multinational companies simply went to jurisdictions where they could produce goods more cheaply.

Globalization may be slowing down but the penetration of technology in business is accelerating. And the year-on-year anomaly of the deflationary period of 2020 will pass and by the second quarter of 2022 core CPI is likely to be below 2%.

In fact, the Fed officials themselves said that in their last meeting, according to its minutes released last week: "Incoming data on inflation were a little above what the staff had expected. The 12-month changes in total and core PCE prices were expected to transitorily move above 2% in coming months, as the low inflation readings from the spring of last year dropped out of the calculation window. In addition, inflation was forecast to be temporarily boosted this year by the expected emergence of some production bottlenecks and supply constraints. Following the transitory increase this year, inflation was projected to run a bit below 2% next year and then to reach 2% by 2023, reflecting tight resource utilization in product and labor markets."

Savvy investors know that and last week were reversing many of the market shifts seen in early March, after the 10-year US Treasury yield rose sharply. Tech stocks, which have a degree of correlation with interest rates and had been battered early last month, led the way last week, though cyclical industries also performed well.

The shock of consumer price inflation, however, could hand the market leadership back to cyclical industries. After all, as was said above, a bit of inflation is a sign of a healthy economy. And, indeed, there are many reasons to believe the world economy is in full recovery mode.

Last week, the IMF updated its World Economic Outlook and said that it now expects the world to grow 6% this year and 4.4% next year, instead of its original projection of 5.5% and 4.2%. Much of it is due to the speed at which the US is vaccinating its population, with the daily number of people inoculated now nearly 30 times higher than the number of new Covid-19 cases.

Cyclical industries and commodities tend to fare well when there is some inflation, since they benefit from rising consumer prices. In that sense, the GCC markets are highly sensitive to the global economic cycle and, therefore could perform well in the coming year.

The S&P Pan-Arab Composite has rallied 53% since March 22nd, 2020, when it bottomed. There is room for more, considering that the MSCI World (which excludes developing nation markets), has risen almost 77% during the same period.

Furthermore, the S&P Pan-Arab is trading at 9.9 times the trailing 12-months free cash flow of its companies, compared to a 17.9 times multiple for the MSCI World. While the S&P Pan Arab is expected to trade at a discount to developed markets, only three years ago it traded at twice the current cashflow multiple — and oil prices were lower then.

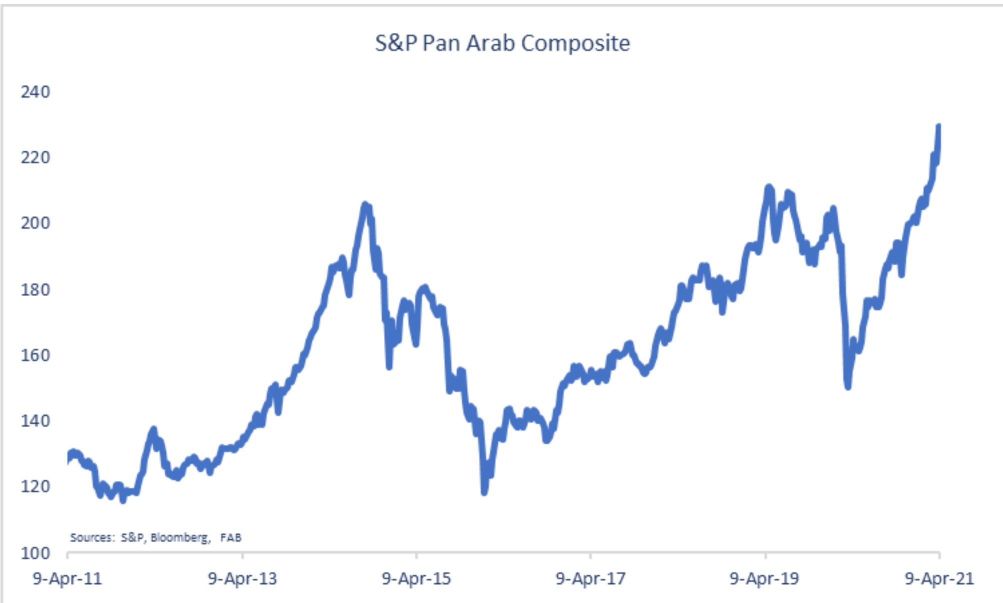
To be sure, oil prices are unlikely to see considerable upside from here, given the amount of supply that can return if prices rise much further. Market downside may also be limited by decent demand recovery. The International Energy Agency expects global demand for oil will end the year around 99 million barrels/day, only 2 million barrels/day short of the record seen at the end of 2019.

In fact, this week may still offer a couple of boosters for oil prices. March retail sales in the US could be up by as much as 20% compared to the same period last year. The number could still have an impact on commodity prices, especially oil even though it will be skewed by a couple of anomalies.

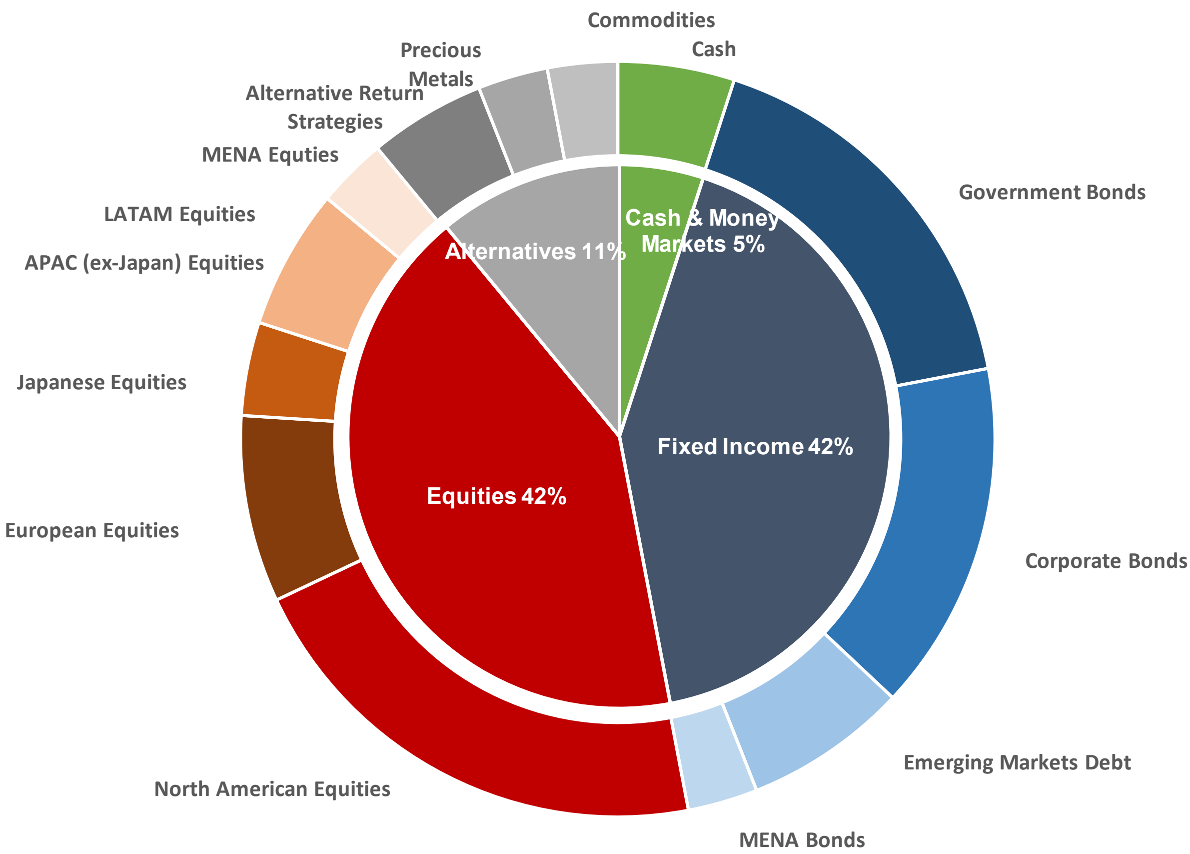
In March last year, retail sales had plunged as the first lockdowns were enacted and Americans became wary of going to malls. This establishes a low base of comparison. Then, in February of this year, unusually cold weather and an unexpected spike in virus cases caused a weaker-than-expected turnout in stores.

The pent-up demand from February compared to the low base of March suggest year-on-year retail sales growth could be as high as 20%, which would be a record. If that is confirmed, it will only further underscore the case for being bullish in risk assets, especially those that benefit from a strong global economy for years to come.

## The main MENA equities benchmark has rallied nearly 53% since March 22nd, 2020



| Asset Class | Positioning | Detail |
|---|---|---|
| Cash | Underweight | Putting cash to work in risk assets. |
| Fixed Income | Overweight | Keeping a slight overweight focused on EM dollar debt and on corporate investment grade bonds |
| Equities | Overweight | Slightly overweight in Asia ex-Japan stock markets. |
| Alternatives | Underweight | However, still marginally overweight in precious metals |



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