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## Inflation creeping up can actually be a good sign

◆ The latest University of Michigan consumer sentiment survey showed expectations that US inflation will spike to 3.3%.

◆ The low base of prices from last year suggests the forecast may be right, but that the move may be temporary.

◆ Risk assets tend to do well when inflation is a bit higher and they only reverse course when the Fed starts to increase rates.

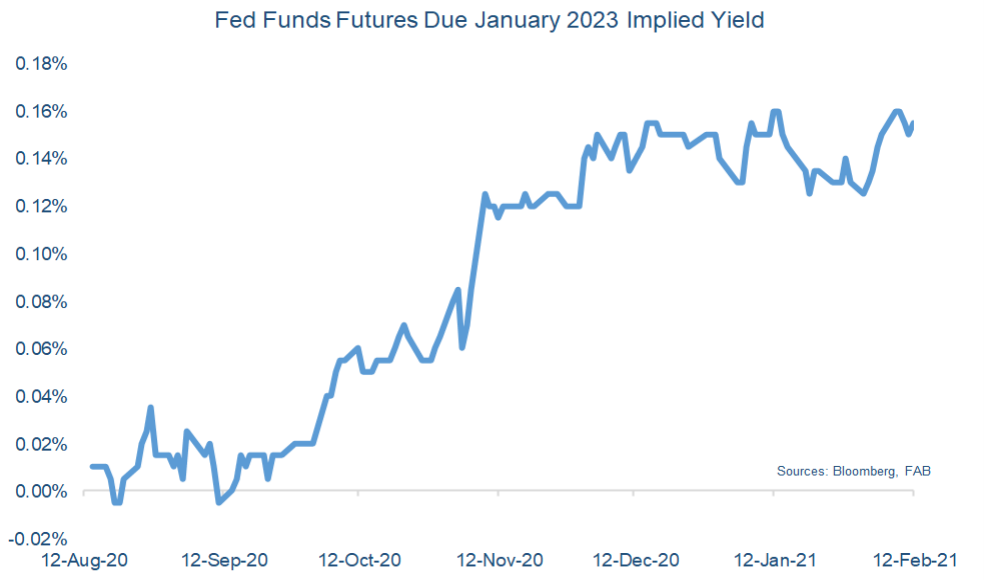
◆ The Fed's minutes this week are expected to show that the central bank does not plan to touch interest rates for a long time, even if inflation shoots up for a little while.

◆ The FAB AAC is overweight in equities, IG and EM bonds, and gold, and is underweight alternatives.

Wall Street has been increasingly convinced that US inflation will push higher, and now Main Street has joined the chorus. On Friday, the University of Michigan consumer sentiment survey revealed that respondents expect inflation to reach 3.3% in the year ahead, the highest print since 2014.

The meaning of inflation for Wall Street and Main Street, however, are different, and have distinct impacts on risk assets. Consumers feel inflation that hits their pockets, whereas Wall Street is worried about the Federal Reserve's reaction to rising consumer prices.

This is important because the inflation that consumers see ahead may already be materializing and, yet, it may have no impact on the Fed's course of action.



Central banks like to look at what they call 'core' inflation, which excludes energy and food prices. To justify this, economists argue that food and energy prices are too volatile and therefore could force central banks to react to what may be a temporary shift in the direction of prices, causing unnecessary economic volatility.

Away from econometric models, people on the street would probably say that food and energy are actually the most tangible part of inflation. And these two elements are on the rise.

The prices of basic staples have risen significantly in the past six months. The price of soybeans, used for a variety of foods, but also important for animal feed, has risen 54.1% in the period. The price of corn, another key input for animal feed, has risen 71.3%. As for humans, wheat prices have increased 29.6%, and rice prices are up 8.7%. Gasoline prices have increased 36.1%, in line with oil, and natural gas, used for heating, is up 35.3%.

### The market has started to price in slightly higher Fed rates in 2023, but only then

Again, none of these numbers really matter so much for financial markets at first glance. In fact, this week the Fed will publish the minutes of its last meeting, and it is likely to show, again, that it is committed to keeping interest rates low for a fairly long period of time, even if inflation rises temporarily. And, again, that is core inflation, without energy or food.

Eventually, however, energy and food prices do start impacting the rest of the system. Higher food prices increase the pressure for wage increases, which then feed into general inflation. Energy prices are also key. Many industries have oil or gas as a key input for production, and as prices increase they will try to pass those additional costs on to consumers.

That process, however, takes a while and can be positive. 'Creeping inflation' is a sign of healthy economic growth, and usually supportive of risk asset prices. Historically stocks and high-yield bonds have performed well in times of creeping inflation. Their performance only starts to lag when the Fed decides it is time to control inflation and starts to raise rates.

This time, Fed officials have said they will be cautious about tightening monetary policy too early, especially after the lesson they learned in 2013. Then, breakeven-predicted inflation rose above 2% for six months, setting off alarm bells in the central bank, which reacted by indicating monetary tightening ahead. The signal triggered the so-called 'taper tantrum' and slowed the economy.

The market reaction and its impact on the US economy have left Fed officials cautious about acting swiftly when breakeven rates indicate inflation ahead. The Fed also changed its framework last year, so it can allow inflation to run above 2% for a while before acting.

The five-year breakeven inflation rate closed the week at 2.38%, the highest since 2013. Breakeven rates are calculated by comparing the yield on normal Treasury bonds and those that pay the inflation rate plus a premium.

Historically, whenever the five-year breakeven rate held above 2%, the Federal Reserve signaled monetary tightening ahead. However, Fed officials have also learned that this metric is a blunt tool with which to predict inflation. In the past decade, the five-year breakeven rate has spent 30 months above the Fed's target of 2%. Meanwhile, the monthly core PCE inflation which the Fed targets went above 2% (and not by much) 11 times.

And even when inflation did breach 2% it was only for brief periods. Plus, it happened shortly after the breakeven was above 2%, and not five years in the future. This may be because bond funds use inflation-protected Treasuries to hedge current inflation, and hence skew the breakeven.

Nonetheless, higher inflation breakeven rates can have knock-on effects that temporarily shake risk assets. Many bond and mortgage funds use these rates in their models for future interest rates, on the assumption that higher inflation will lead to higher interest rates.

Some money managers might reduce the duration of their bond portfolios, or short long duration bonds to hedge the risk of higher rates. Mortgage investors may also short long-dated Treasuries, as they expect fewer people to refinance their loans in the future. These moves may explain why 10- and 30-year US Treasury yields hit their highest in a year last week.

As for riskier assets, they tend to do well in environments with slightly rising inflation, as mentioned. This suggests stronger growth ahead, and also means that debt values should start to drop relative to the value of assets, which increases the value of equities and of companies in general.

Markets have reflected that in the performances of the various asset classes so far this year. The 10-year Treasury has lost some 2.4% in price as yields rose nearly 30 basis points.

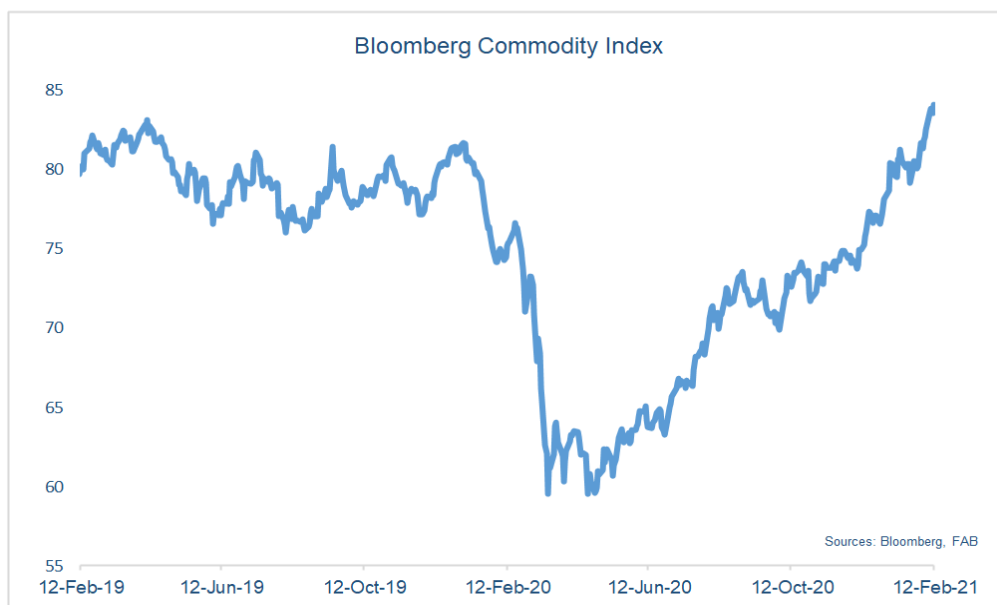
Commodities are among the best-performing assets so far this year, with the Bloomberg Commodity index having risen 7.7%. Stocks are not too far behind, with the MSCI All-Country index up 5.6%.

High-yield bonds, which are more correlated to stocks than government bonds, are also up. The Bloomberg Barclays US Corporate High-Yield index has gained 1.32% year-to-date, and on Friday its yield to maturity fell below 4% for the first time ever.

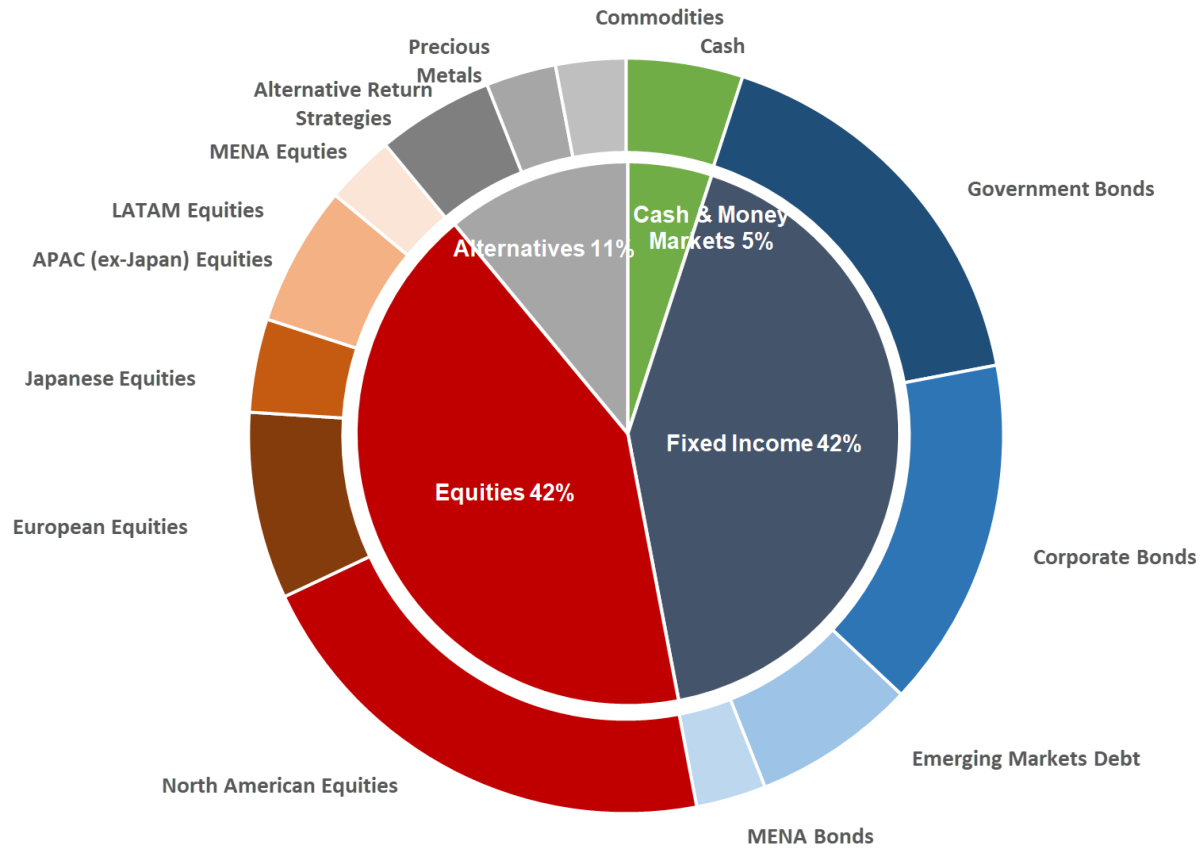
An asset class that could now perform well is real estate. Home prices tend to rise with inflation, and normally react positively to low interest rates. Sure, in some markets excess supply may curb those gains, but globally the asset class could indeed perform quite well.

To reiterate, a bit more inflation is not always a bad thing. It only starts to become a problem when it rises so much that central banks have to stamp it out. But that is not likely anytime soon, which means there is room for risk assets to continue their rally.

### Commodities, which benefit from higher inflation have been in a tear this year



## Current Tactical Asset Allocation



Asset Class	Positioning	Detail
Cash	Neutral	Moved into overweight equities position.
Fixed Income	Overweight	Keeping slightly overweight focused on EM dollar debt and corporate investment grade bonds
Equities	Overweight	Slightly overweight Japanese, US and Asia ex-Japan stock markets.
Alternatives	Underweight	However, still marginally overweight in precious metals

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