Global macroeconomic update

Key themes

- As expected, much of the debate in Q2 has focused on higher inflation, how transitory it may or may not be and how the Fed will react
- Several key market indicators have not yet sounded the alarm on imminent surge in inflation; however, some anecdotal observations would suggest otherwise
- We continue to believe rates will move higher from here and remain notably underweight duration versus benchmarks; we particularly like being short European duration

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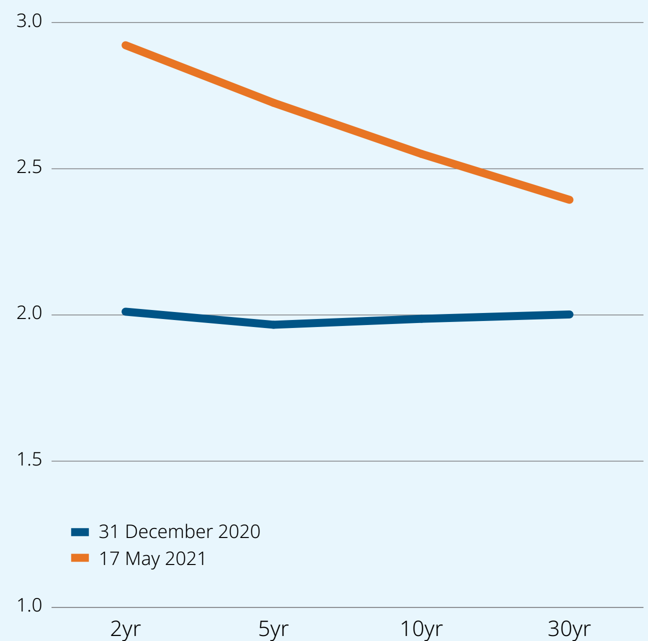
Separating the Signals from the Noise

Turning points in the cycle are always notoriously difficult to call – and time – and we are now very much in the thick of it. Separating the inflation signals from the noise has been and will continue to be challenging over the next few months as the most recent US payrolls and CPI data misses for April confirmed, all the while the anecdotal evidence seems to be pointing in one direction: higher.

Our general view heading into the "base effects" portion of inflation data for March, April and May (reported with a one-month lag) was inflation would probably run a little hotter than just the impact of the base effects, but not run away higher. Successive monthly prints for March and April of 0.6% and 0.8% for US headline CPI and 0.3% and 0.9% for core CPI, respectively, is suggestive that we could be at the very top of the pre-runaway stage with the May CPI data still to print.

Yet despite this, we have been increasingly confident the Fed's June meeting will be too soon for it to signal a material change in tone and the data misses seem to underscore that view – i.e. more time will be needed to see if prices will reset back to "normal" on their own (and to see what happens with the labour market). Indeed, since the April CPI release the Fed has had numerous opportunities to push back or amend its message, including scheduled remarks from Vice-Chair Clarida and it has not only opted to hold the line, but continued to use the "transitory" language with respect to the near-term pop in inflation. Many market indicators would agree, including the all-important TIPS breakeven curve which remains inverted with the 2yr breakeven trading around 17bp higher than the 5yr and 34bp above the 10yr breakeven at time of writing (please see chart 1). Additionally, another Fed favourite, the 5yr5yr forward breakeven rate is currently below 2.40% and while it has been moving steadily higher since last year it is worth noting the rate remains well below the 3.00% from late 2009 in the immediate aftermath of the global financial crisis.

Chart 1 | US TIPS Breakeven Curve
(Dec 31, 2020 & May 17, 2021, %)

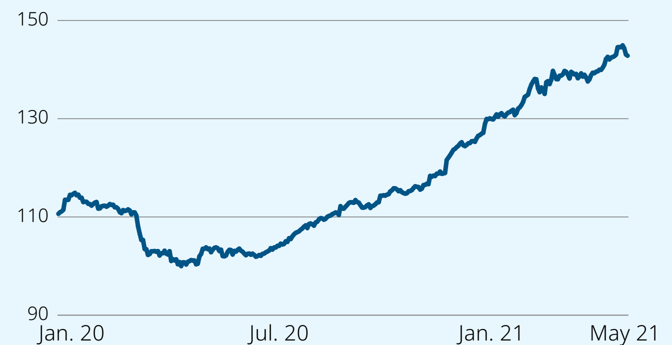


Sources: Bloomberg; Mackenzie Investments

But this is not 2008-09. Global fiscal and monetary stimulus is much more pronounced, the savings rate has ballooned and the world has become more integrated since the global financial crisis of 2008 with supply chain disruptions (stories of which have been piling up the last few weeks) presumably having an even larger impact on prices. One of the less obvious takeaways from the US Q1 GDP report was the massive drawdown in subtracting 2.5 percentage points from headline real GDP inventories as the US economy opened up more quickly than many anticipated. With low interest rates, very high savings rates and personal consumption showing no signs of abating, those inventories will likely need to be replenished. Moreover, if you bought lumber at Home Depot lately to spruce up your deck or you required new copper piping after running your furnace all winter (since there was nowhere to go) you know firsthand the price of raw materials is up...materially. Indeed the CRB's Raw Materials Price Index is up 43% since the lows in April 2020 (please see chart 2). This is not just a North American phenomenon; Chinese demand is also having an impact here.

Chart 2 | Commodity Research Bureau US Raw Industrial Index

(Daily, Indexed to Apr 2020 low, Jan 2020 - Present)



Sources: Bloomberg; Mackenzie Investments

Then, there are the stories about higher wage pressures. The National Federation of Independent Business (NFIB) survey, which focuses on small- and medium-sized business, said after its April 2021 release that, "Many small business owners who are trying to hire are finding themselves unsuccessful and are having to delay the hiring or offer higher wages. Some owners are offering 'show up' bonuses for workers who agree to take the job and actually show up for work." The NFIB went further saying, "Ninety-two percent of owners hiring or trying to hire report few or no 'qualified' applicants for the positions they were trying to fill in April." Indeed it appears the combination of large federal and state unemployment benefits as part of President Biden's $1.9trn Covid relief package has created a structural imbalance in the labour market; some surveys suggest that even when earning $32,000 a year you are as well off by staying home rather than going to work. The labour market is so imbalanced and wage pressures so distorted that at least 19 states have or are in the process of opting out of the federal unemployment subsidy program.

So all told markets seem to mostly be saying inflation is escalated but not running away while other more anecdotal and survey based indicators seem to suggest we could be on the cusp of something more pronounced. The Fed's Vice-Chair Clarida recently reminded the market that survey-based indicators of expected inflation could be just as important as actual inflation. In this regard, the University of Michigan's survey about expected change in prices for the next 5 to 10 years – another Fed favourite - recently touched a fresh cycle high of 3.1% y/y, the highest since early 2011. Indeed, it will continue to be challenging to separate the signals from the noise. One signal we are watching: if the Fed's June forecasts adjust its view for 2022 inflation so that it is more even with expectations for 2021, it likely means the Fed is about to get more hawkish.

We continue to believe the prudent move at this point in the cycle is to position for higher rates and the fixed income team remains quite underweight duration versus benchmark. We continue to believe both underlying inflation pressures and upside risks to growth with a Fed that is willing to be patient a while longer in order to help achieve its new Flexible Average Inflation Targeting (FAIT) framework suggests the balance of risks for rates is higher from here. While not only expecting higher rates in the US and Canada, we continue to particularly like being underweight European sovereign duration as we believe the pace of reopening has not been priced in; this is true for not only the German benchmark, but also for peripheral economies particularly Italy which could come under added pressure if the European Central Bank tweaks its Pandemic Emergency Purchase Program (PEPP) as we expect at its June meeting.

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