The Trades

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Inflation and the Fed - no pressure...

by Cranley Macfarlane

Since last March, the pandemic has dominated investment markets. While it is by no means over, the success of the vaccination programmes in the US, UK, and now Europe, mean that Covid-19 may no longer need to be investors' no.1 concern. Despite this good news, market conditions in May have been as temperamental as the UK's current, inclement weather. In fact, the positive impact of vaccines began to be priced in some time ago and with much of the stock market looking expensive, it is the looming threat of inflation that is making investors skittish.

As inflation is calculated by measuring the change in prices over a year, it is unsurprising that it is spiking now. Last year commodity prices plummeted amid the massive global economic shock, with the oil price briefly even turning negative; but prices recovered and so their influence on inflation will wane over the coming months. However, these base effects are not the only driver.

The pandemic has caused all sorts of problems for supply chains. Shipping costs have soared as containers were stranded in the wrong parts of the world due to lockdowns, exacerbated by the mother of all traffic jams in the Suez Canal. Lockdowns, a frozen Texas, even a fire in a Japanese semiconductor factory, have all held back factory output at a time when demand was recovering, pushing prices higher.

Demand, in and of itself, is also inflationary. For example, the price of lumber in the US increased 93% since January due to demand from housebuilders. In China, the government has acted to cool the iron ore price, which had increased 94% since November on demand from steelmakers. In the labour market, the likes of Amazon and McDonalds have raised wages to try and attract workers back to the workplace.

The feared result of all these inflationary pressures is an increase in interest rates, the timing of which is a delicate matter. Too soon and the higher rates may choke off economic growth; too late and the economy may overheat, requiring steeper rate rises, and ultimately risk a recession. In the US, the Federal Reserve is adamant that the current level of inflation is transitory and will fall back to its 2% target. Only now are they starting to talk about talking about the tapering of monetary support. Last month's inflation reading of 4.2% was the highest in 30 years, and might not yet be the peak, and so the pressure on the Federal Reserve will only build.

In the Endeavour fund we are invested in certain sectors of the economy that can fare relatively well in an inflationary environment. Our exposure to banks, including JP Morgan and Bank of America, should benefit from the prospect of higher interest rates. Higher commodity prices are a positive for our mining and energy companies, such as Anglo American and ConocoPhillips. Consumer companies with strong brands, like P&G and Nestle, can more confidently pass on higher costs to the consumer through price hikes, thereby protecting their margins. Gold, as well, is the classic inflation hedge and certainly more proven than the volatile Bitcoin.

Hopefully though the Federal Reserve are calling it right, and we can enjoy the summer (when it arrives) without any untoward market shocks.