Inflation worries on hold:. **Investment Strategist Peter Lucas explains why he expects to see inflation concerns resurface and how this may impact markets.**

Back in May the consensus opinion appeared to be fully behind the inflation story. Commodity prices were soaring, with the Fed apparently doing everything it could to fan the flames. US inflationary expectations, as measured by the inflation-linked bond market were well above 2%, the Fed's long-term average target level. The ISM Prices Paid Index hit its highest level since the dark days of the 1970s. And then, to cap it all, US consumer prices were announced to have risen 4.2% and 5.0% in the twelve months to April and May, the latter being the highest such number since 2008. With all that going on one might have expected to see carnage in the bond markets, but not a bit of it. Indeed, the US 30-year yield peaked at 2.51% as long ago as March (now 2.06%) and 5-year inflationary expectations peaked in May at 2.82% (now 2.52%). So, what gives?

Part of the explanation lies with excessive positioning. Having bought into the inflation narrative, investors had already adjusted their portfolios, leaving an overhang of stale 'inflation bulls' in the commodity and inflation-linked bond markets. These positions were subsequently shaken out when the Federal Reserve shocked the world by announcing that they might raise interest rates in two years' time. How the Fed can be described as 'hawkish' with such a statement is beyond me, but the fact that it has says much about the current investment environment.

As touched on earlier, the Fed now has an average inflation target rather than a hard inflation target. Before, the Fed would typically tighten monetary policy when inflation exceeded its target. But now, under the new policy framework, they say that they are happy to let the economy run hot for a period to compensate for periods of inflation undershoot. Beyond that, they have not been particularly forthcoming. Perhaps they will target inflation over the full economic cycle. With the 7-year average for US Personal Consumption Expenditure Core Price inflation (the Fed's preferred inflation measure) standing at just 1.63%, one can see why they are not in any hurry to tighten policy.

It is quite possible that inflation might ease back a touch in the near term as some seem to think, but the risks remain skewed to the upside. Aside from the fact that the Fed wants inflation to go up, at least for a while, there are a legion of other risks, including: deglobalization, the 'Green' agenda (enforced switching to inferior technologies), the risk or likelihood of a spike in the oil price and easy fiscal policy. Furthermore, when I look at the markets themselves, I see charts that are very much consistent with that view:

- Bond yields that are still very low relative to both inflation and trend economic growth.
- Bond yields that, despite recent corrections, are in generally in uptrends.
- Commodity prices that have experienced orderly corrections in ongoing uptrends.
- A spot oil price (WTI) that is attempting to break its post-2008 downtrend.

This latter point deserves further comment. In my last article I talked about the way in which the ESG agenda was starving 'dirty energy' companies of capital and constraining their ability to expand production in response to rising demand. Clearly oil producers outside the developed world could fill the gap, but will they? In the 1970's they withheld supply to boost prices; this time around, they simply have to sit on their hands.

Another interesting chart is that for the Chinese yuan versus the US dollar. Having strengthened significantly between 2005 and 2014, the yuan has essentially flatlined against the dollar. However, more recently it has been strengthening again due to the generally weak dollar and the policy divergence between the two countries. Again, this is another theme discussed in my last note. If China recognizes the folly and futility of supporting their currency against the US dollar and allows it to appreciate, the resulting dollar devaluation would feed into the developing US inflation story. The seven-year uptrend, which the dollar-yuan exchange rate is currently just above, provides us with a clear level to monitor for evidence that this story is unfolding as expected.

The recent drop in long-term interest rates has provided a window of opportunity for growth stocks to move back into the limelight. In just seven weeks, the NYSE FANGS index has risen almost 17%, all but matching its February all-time high and beating the equal-weighted S&P 500 by 12%. Anatole Kaletsky (Gavekal Research) has recently argued that growth stocks are in a bubble but have yet to have their 'killer wave' in which valuations go from high to ridiculous. Certainly, the Nifty Fifty, NASDAQ 2000 and real estate bubbles only burst when short- and/or long-term interest rates got close to or above trend economic growth, and they are still a long way from reaching that sort of level. All the same, with reasonable valuations and a recovery story that has some way left to run, value stocks look a much safer and compelling proposition.

Bottom line: expect the recovery/inflation story to return before too long.

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