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***Strategy Update:* Investment Strategist Peter Lucas reviews his current outlook for markets.**

In my last detailed strategy piece (Final piece of the jigsaw, February 2021) I described the upside breakout in bond yields as being a "a big deal because it marks the beginning of the next exciting phase of the story". Two-and-a-bit months on, we see that markets have largely conformed to expectations, albeit that we yet to see the fireworks envisaged in that article. Bond yields are higher, but not massively so. Value stocks have performed well, leaving growth stocks in their wake. The broad commodity index has hit new highs for the year and is at levels last seen in 2014. Precious metals, described as being "poised to resume their uptrend", are still poised.

The resilience of bonds is a bit of a surprise, particularly when you consider that the US ISM Business prices index is close to a seventy-year high and has just registered its biggest rise since the 1950's. On the other hand, bond yields had already risen sharply, particularly in America and Britain, investor positioning was already quite extreme and COVID has shown that it is not quite ready to slink into the background, particularly in places like Latin America and India. Furthermore, central banks have been at pains to say that they are in no hurry to raise interest rates and will even consider upping their purchases of bonds if the rise in yields gets out of hand. Nonetheless, there is plenty more room for bond yields to rise in the months ahead.

The investment community is bitterly divided on the issue of inflation. Well known bond-bull Gary Shilling, who has been on the disinflation story since the early 1980's, is adamant that the underlying story has not changed, particularly given the mountains of debt overshadowing developed world economies. Similarly, Chen Zhao, Alpine Macro's excellent strategist, has said that he is not overly concerned by recent evidence of supply-side bottlenecks and accelerating inflation. But then we have the likes of Charles Gave (co-founder of Gavekal) and Russell Napier who are seriously concerned about inflation. When such heavyweights disagree, what are we to do?

Let us start by focusing on what we know, or at least what we think we know. First, despite recent market moves, it is still cheaper to position for reflation/inflation than the opposite. Bond yields are still the wrong side of fair value, growth shares (that have benefited from low bond yields) are way more expensive than their more cyclical value counterparts and even commodities are not that expensive, despite a rise of over 100% in the broad index since last April. Second, whatever the immediate term outlook for inflation, we can be pretty sure that it will feature in the story at some stage in the future. Governments are massively in debt and if history is any guide, it is highly likely that some combination of inflation and financial repression (holding interest rates persistently below inflation) will be their solutions of choice. Third, the globalisation story, which has been a major anti-inflation discipline, is going into reverse as America turns up the heat on China. These are all compelling reasons to take the inflation story seriously.

Ten years ago, who would have thought that the Fed would have a policy of pushing inflation up? As crazy as it still sounds, that is where we are. It is a dangerous policy, not that they have much choice under the circumstances. They say that if inflation does rise, they have the tools to bring it under control. But I see massive risks in that strategy, and as much as I have sympathy with the benign inflation view, I feel that the risks are now skewed in the other direction.

Having spent a month going sideways, bond yields are now breaking out again on the upside. This is going to make life difficult for growth stocks, at least on a relative basis. Equities generally should continue to do well until there is clearer evidence that inflation is trending higher. That should happen later this year. Even then, with rates glued to the floor, the downside risks to the more cyclical parts of the equity markets are probably limited. The case for gold is slowly improving. Although rising bond yields will remain a headwind, the likelihood is that the US dollar will weaken, particularly as the rest of the world catches up with America's vaccination success. Furthermore, nothing gets gold more excited than accelerating inflation.

So broadly speaking, markets continue to follow the game plan that we first outlined back in June of last year. One thing that has not conformed to expectations recently is market volatility, which has been dropping recently rather than heading higher. With the Fed playing with dynamite, it is hard to see that remaining the case for too long.

Peter Lucas

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