Pikes Peak. Colorado Springs. United States

HOUSE VIEW

JULY 2021

PIKES PEAK:
SKY HIGH INFLATION

BancaMarch

PIKES PEAK: SKY HIGH INFLATION

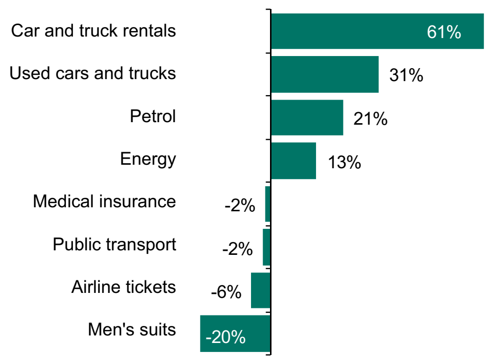
The US summer season traditionally kicks off with the automobile hill climb of the 14,115-foot fourteener Pikes Peak, a savage ascent by psychedelic cars held in Colorado Springs every year since 1916. Spanning 13.5 miles with 156 bends, the track is enough to put any driver's skill and courage to the test. The spectacular event and the 4,720-foot track have earned the hill climb the nickname "The Race to the Clouds".

This year, with a robust economic recovery underway and equities and inflation both at highs, this race to the summit takes on special symbolism as we head into the summer holiday period. As climate change makes itself felt and the northern hemisphere starts to feel the heat, US inflation is embarking on its very own Race to the Clouds. The shopping basket was up 5% year on year in May and core inflation rose by 3.8%, hitting the highest levels in 30 years.

There is no denying that the impressive post-Covid recovery is triggering price increases far beyond the base effect of commodities and oil. After many months of lockdown people are desperate to travel, which has had a highly significant impact on other components. Despite representing just 8% of the shopping basket, cars - especially pre-owned cars - drove half of the core CPI increase in May, with prices up 30% versus pre-pandemic levels.

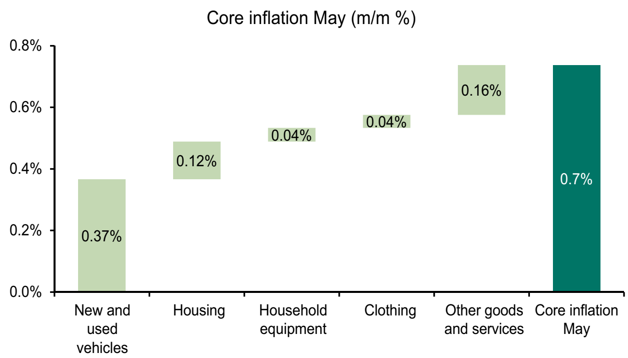
1. US PRICES VS FEB 2020

Sources: U.S. Bureau of Labor Statistics, Bloomberg and Banca March



2. CONTRIBUTION TO INFLATION INCREASE

Sources: U.S. Bureau of Labor Statistics, Bloomberg and Banca March

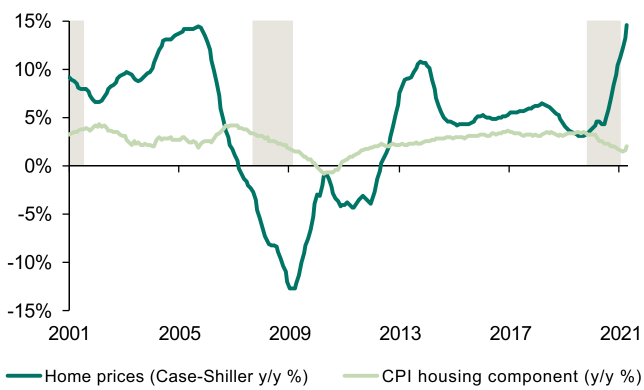


This is an excellent example of the adverse impact on prices when the a sector struggles to balance a sudden spike in demand – which fell to practically zero throughout the months of the pandemic – with supply shortages, in this case due to failing supply chains for new vehicles and a lack of semiconductors.

Fortunately, the cost of rent and shelter, for example, which accounts for 42% of core inflation, has remained relatively contained, rising by 2%. This is one of the largest risk factors going forward, as record highs in house prices – which are up 16.7% versus pre-Covid levels – could end up translating to higher rents.

3. HOUSE PRICES VS SHELTER CPI

Sources: Bloomberg and Banca March



That being said, history has taught us that in practice, rising house prices do not tend to be reflected dramatically in the shelter component of the CPI. It is worth bearing in mind that the price of the shopping basket is calculated based on a series of surveys on the supposed price one would pay to live in a property; as a result, as the figure shows, the peaks are not as steep.

Meanwhile, the Fed continues to insist that the spike in inflation is transitory and is working hard to drive home an accommodative message, pushing the perspective that these price hikes will only be temporary and that expansive conditions will remain in place for the foreseeable.

We do not have the slightest doubt that factors such as technology, population ageing and a degree of globalisation more in line with the last decade will be prominent over the long term. However, the question we should be asking ourselves now isn't whether or not this inflation will be transitory, it is this: How long can the Fed extend the current pace of unprecedented stimulus measures, and will it be able to maintain the honeymoon phase it is currently enjoying with the markets?

In the last few weeks, not only has this sweet spot been reflected in widespread equity market highs; the US rate curve has flattened even further. the 2/10 year curve has gone from 1.6% to 1.08%, whilst 10-year inflation breakeven rates have dropped 35 bps to 2.25%, which shows that the markets are buying into the argument that the spike in inflation is transitory.

At the moment, the markets are unperturbed by data like unemployment figures, which show that in the last 3 months, 93% of industries have suffered above-average salary pressure and that aggregate wages are now 2.8% higher than pre-pandemic levels. But will the markets continue to overlook this "transitory" rise in wages?

As summer 2021 kicks off with the Pikes Peak hill climb, inflation's own Race to the Clouds has reached a turning point, but we must get one thing straight. It will be several months before this transitory spike in inflation begins to subside. With oil at 75 dollars a barrel and some of the factors outlined above starting to come to the fore, inflation could close the year at over 4%. From now on, the Fed will need to offer comprehensive explanations, and, above all, stimulus tapering announcements. The outcome for the markets will be anything but tragic: we must remain invested, but volatility is set to rise.

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IMPORTANT REMARK: