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# Inflation Returns (Part 2) and Trade Wars

Because the threat of inflation (in the US) and its consequences has been the primary mover of markets recently, I am returning to the subject for a second week. The good news is that there have been no material negative data points since last Monday. In fact the Federal Reserve's (Fed) preferred measure of inflation, the Personal Consumption Expenditure Core Price Index, which was published last Thursday, printed at an annual rate of 1.5% for January, unchanged since December. Yes, it has risen from 1.3% last summer and is trending higher, but it is still well short of the Fed's target of 2%, a level last seen in 2012.

Decision-making at the Fed is now in the hands of the new chairman, Jay Powell, who has replaced Janet Yellen. He has yet to host his first meeting of the Open Market Committee that sets interest rates. However, he did make his inaugural appearance before various Congressional committees last week, and his first comments on Tuesday did make some waves. It might just have been a classic rookie error, which is exactly what his predecessor was guilty of at her first press conference four years ago. Ms Yellen made an unscripted remark about the possibility of starting to raise interest rates within the next six months and the US 10-year bond yield spiked 10 basis points higher immediately. She was a lot more circumspect thereafter. Mr Powell's official scripted comments were fine, but in the Q&A session he accentuated the positives in terms of global growth and recent tax cuts, and these comments were interpreted as "hawkish". He "only" managed to put 7 basis points onto the bond yield, but did knock 1.6% off the S&P 500. Cue a huge damage limitation exercise when he appeared before Senate two days later: "There's no evidence the economy is overheating". He's a fast learner!

That leaves us dependent on the next sets of data, and this Friday promises to have traders biting their nails in anticipation of the monthly employment report. Remember that it was last month's release that triggered the correction. Current forecasts suggest wage growth was unchanged at 2.9%, which should not scare the horses unduly. I ought to point out that the market becomes obsessed with certain indicators on a regular basis, and anything to do with inflation is now going to be scrutinised to within an inch of its life and create headline (financial) news.

Not all inflation has the same roots. Classically, it comes in two main forms: "cost push" and "demand pull". The former is driven by a shortage of supply of either goods or labour. The latter is driven by an excess of demand. There is an element of both at work currently. With unemployment falling close to 4% in the States, and projected to continue falling, there are signs that labour shortages are developing in certain skilled industries. On the demand side, the recent tax cuts, initially received so enthusiastically for their positive effect on corporate earnings, are being reassessed as the equivalent of pouring petrol on an already well-lit bonfire. It is unprecedented for so much stimulus to be applied to the economy so late in the cycle. Now is the time when funds should be put aside for a rainy day. Instead, the US could conceivably reach the end of the current economic cycle with a record peace-time deficit. That, alongside the inflation concerns, is another factor putting upward pressure on bond yields.

And now, to make things worse, we have the rising threat of trade wars, another potentially inflationary factor, as global supply chains are disrupted and local prices are boosted by import duties. The latest episode started a few weeks ago with Trump imposing tariffs on imports of solar panels and washing machines as part of his "America First" policy. China, the main target of the tariffs, threatened to respond with its own charge on imports of sorghum, a vital grain. This was a cleverly chosen target, intended to hit the farming states that were a key component of Trump's winning vote. Last Thursday, unexpectedly, the president announced new tariffs on imports of steel (25%) and aluminium (10%). This provoked the ire of the European Union, which, taking the same line as China, threatened its own charge on iconic American imports such as Harley-Davidson motorcycles and Kentucky bourbon – again, very much aimed at the Republican heartland. Trump immediately struck back by threatening new taxes on European cars.

Depressingly, this all smacks of playground behaviour: tit-for-tat escalation and very little consideration for the consequences. There is much questioning of Trump's motives. No doubt he needs to shore up the party vote ahead of next autumn's mid-term elections, so is playing to the Republican gallery. There is also a suspicion that this is a classic deflection strategy to divert attention from the Robert Mueller investigation into alleged misconduct during the election campaign. Neither feels like a basis for sound policy.

Economic and monetary policy mistakes have for some time been high on our list of possible threats to market equilibrium. We retain some faith in central bankers, but the last few days have definitely reduced our confidence in politicians (was that even possible?!). This comes at a time when markets remain fragile following the recent correction, and can only be seen as an unhelpful development. I have mentioned before that it is our aim gradually to de-risk portfolios as we approach the end of the current cycle. The latest events could accelerate the process. We certainly need the "adults" in the US political system to impose themselves on the situation. Finally, it was Pietro Mascagni who wrote the opera Isabeau. This week, which cartoon character's name is derived from the traditional anglicised form of Livorno in Italy?

**John Wyn-Evans**
Head of Investment Strategy

## FTSE 100 Weekly Winners

| | |
|---|---|
| Sky | 24.4% |
| Burberry Group | 6.1% |
| Shire | 6.0% |
| International Airlines Group | 4.7% |
| Persimmon | 4.5% |
| Evraz | 2.8% |
| Pearson | 2.7% |

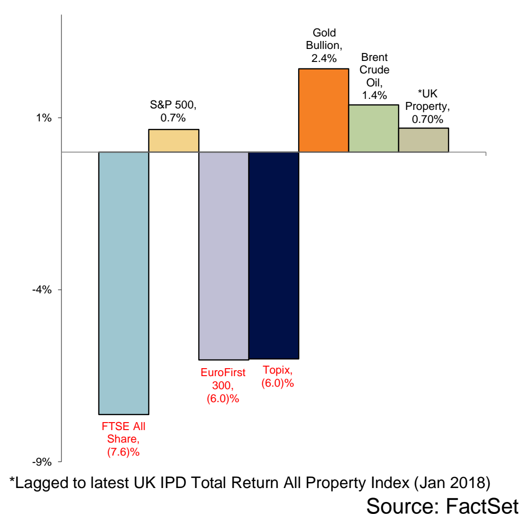
Source: FactSet

## FTSE 100 Weekly Losers

| | |
|---|---|
| ITV | -9.8% |
| Rio Tinto | -9.1% |
| Fresnillo | -8.7% |
| Glencore | -8.0% |
| Rentokil Initial | -7.2% |
| BHP Billiton | -6.8% |
| WPP | -6.6% |

Source: FactSet

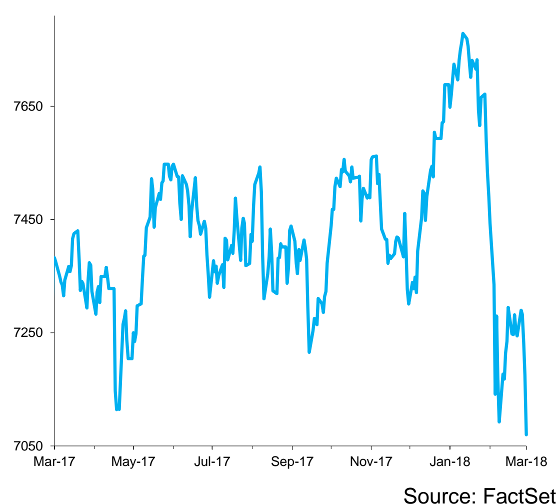
## Year to Date Market Performance




*Lagged to latest UK IPD Total Return All Property Index (Jan 2018)

Source: FactSet

## FTSE 100 Index, Past 12 Months




Source: FactSet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