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WM Chief Investment Office
13 May 2021

Market Watch

Inflation Strikes Back

Near-term volatility likely

Summary

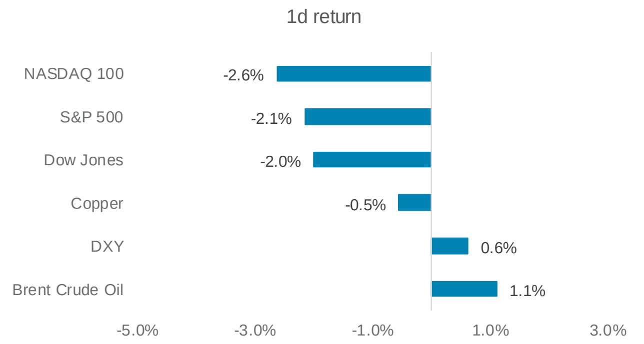
The US April inflation report surprised significantly on the upside. CPI inflation jumped 4.2% y/y, up from 2.6% in March, the biggest rise since September 2008.

US equities under short-term technical pressure. The S&P 500 broke below first level of technical support, while Nasdaq-100 weakness continued.

Maintain preference for Value sector equities. We would use volatility to average into our preferred US equity sectors: Energy, Materials, Industrials and Financials.

Sharp rise in inflation hurt equities

Performance of selected asset classes on 13-May



Source: Bloomberg, Standard Chartered

Background

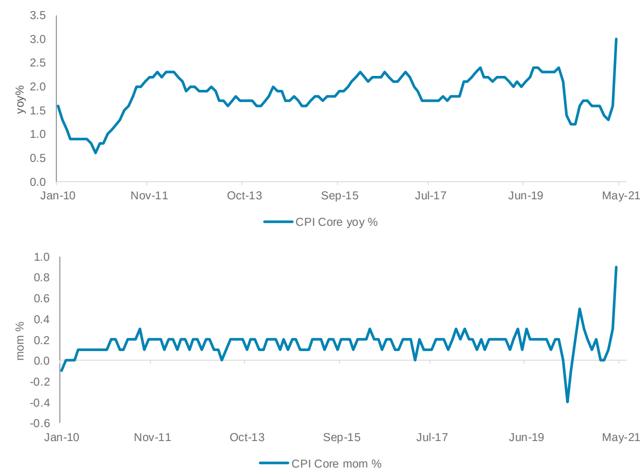
Sharp rise in both US headline and core inflation. Headline inflation rose 0.8% m/m, significantly above the anticipated 0.2% m/m. Core inflation surged 0.9% m/m, the highest rate since April 1982, and exceeded expectations that it would remain at 0.3% m/m.

Significant firmness in core inflation. Even after excluding three categories with unprecedented m/m increases (lodging away from home, airline fares and used cars), core inflation would have risen by 0.4% m/m, which is still higher than consensus expectations. However, what is also key is whether the inflation rise is persistent, as at least some of the rise is likely driven by temporary factors such as statistical base effects.

Technical weakness in S&P 500. The S&P 500 index has broken its “higher highs, higher lows” bullish technical pattern, after dropping below key support at the mid-April low of 4,118. This indicates pressure on the index in the short-term. The next level of support is the critical 4,000 level, followed by the 100-day moving average at 3,933, and the 200-day moving average at 3,693, 9% below Wednesday’s close.

Sharp acceleration in core inflation

US core inflation (y/y and m/m)



Source: Bloomberg, Standard Chartered

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What does this mean for investors?

Growth stocks likely remain under pressure short term. Growth sensitive stocks are susceptible to rising inflation and the subsequent likely rise in yields, which hurts their valuations because of the higher 'discount' rate implied by higher bond yields. Growth indices like the Nasdaq-100 were already showing short-term technical weakness even before the inflation print. Major technical indicators (including the 'wave-count' and cross-over indicators like the MACD) are indicating further downside is likely ahead. Critical support is at 12,000, a break of which is likely to lead to sharper falls.

We reiterate our theme of "Rotation into Value". Despite the poor performance of equities across the board, we believe a rotation into Value stocks as the dust settles is likely to remain attractive. We continue to view them as an attractive play on further reopening of economies, infrastructure stimulus, and as potential beneficiaries of higher inflation (higher bond yields can be a positive factor for value-style outperformance). We would adopt an "averaging-in" approach to our Preferred US sectors, such as Materials, Energy, Financials and Industrials.

What's next?

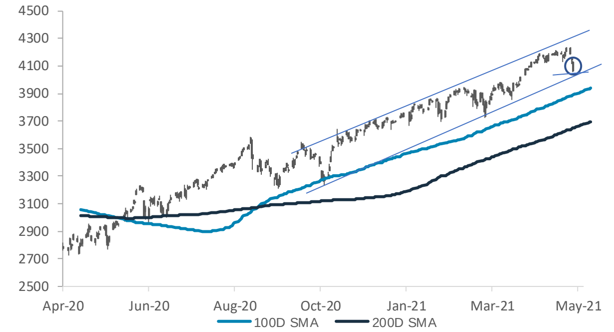
The Fed's reaction is key. In our assessment, the Fed is unlikely to react to higher inflation for now given it expects inflation to decelerate in 2022. To quote Fed Governor Lael Brainard, "a limited period of pandemic-related price increases is unlikely to durably change inflation dynamics".

Also, the Fed has clearly communicated that any policy tightening hinges not only on inflation dynamics, but also on the labour market. Moreover, the Fed's new average inflation targeting mandate raises the bar for a policy response.

As such, we believe volatility in risk assets is likely to persist in the short-term. Given the high hurdle for the Fed to react, however, this is likely to provide opportunities for long-term equity investors, especially in the sectors aforementioned.

S&P 500 index key support at 4,000

S&P 500 index price chart



Source: Bloomberg, Standard Chartered

Nasdaq-100 weakness continues. 12,000 critical level of support

Nasdaq-100 index price chart

Source: Bloomberg, Standard Chartered

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