Heartwood
Investment Management

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Investment Insight

Weekly Insight

Investors hold their nerve as US inflation edges higher

All eyes were focused on US inflation data this week, but curiously, financial markets barely flinched in response to a higher-than-expected report for January. It was yet another test of investors' mettle after the volatility we saw last week. Equity markets maintained their composure, though, making modest gains in recent days, while ten-year US treasury yields rose steadily towards 3%.

Should investors take solace from such a becalmed response?

The US inflation report is only one data point, but nonetheless the market reaction provides some reassurance that investors are adjusting to a higher interest rate and higher inflation environment. The main surprise came from core inflation (excluding food and energy), which increased a higher than expected 0.3% month-on-month in January. This represents the largest monthly increase since March 2005 and takes the three-month annualised gain on core inflation to 2.9%. Several factors contributed to the steeper climb, including price rises in more volatile items such as clothing and home furnishing; we may therefore see some moderation in subsequent inflation reports.

This inflation reading together with January's wage gains have prompted a sceptical US treasury market to almost fully price-in a March interest rate rise. Where there appears to be less consensus, however, is around the ultimate path of the US Federal Reserve (Fed) tightening cycle. Current US treasury market pricing suggests that investors remain unconvinced that the Fed will have to move faster or more aggressively beyond three interest rate hikes for this year.

In our view, the bond market's assessment is probably too benign and US treasury yields will likely have to play catch-up with the Fed at some point. If our central view holds, then the early February wobble is probably the starting point for further market tremors as we move through the year. This expectation is not to be feared. In fact, 2017 was the anomaly. Such benign conditions were unlikely to persist, especially as global central banks consider their exit strategies from emergency levels of monetary stimulus. We are simply returning to more normal market conditions.

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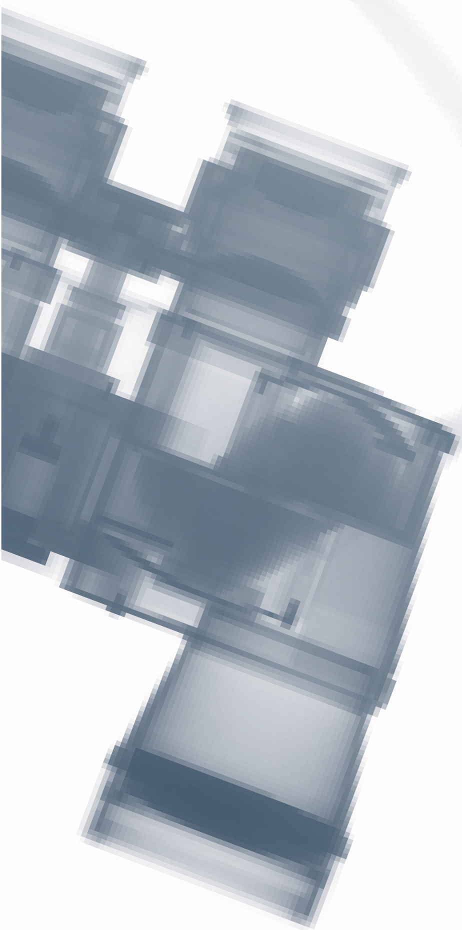
Investment Director



US inflation data moves higher than expected

US Core CPI growth rate (% change 3m annualised)

Source: FactSet

Clear Thinking

Past performance is not a reliable indicator of future results.

Contact

To find out more about the Heartwood strategies, visit our website or contact your local representative.

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