



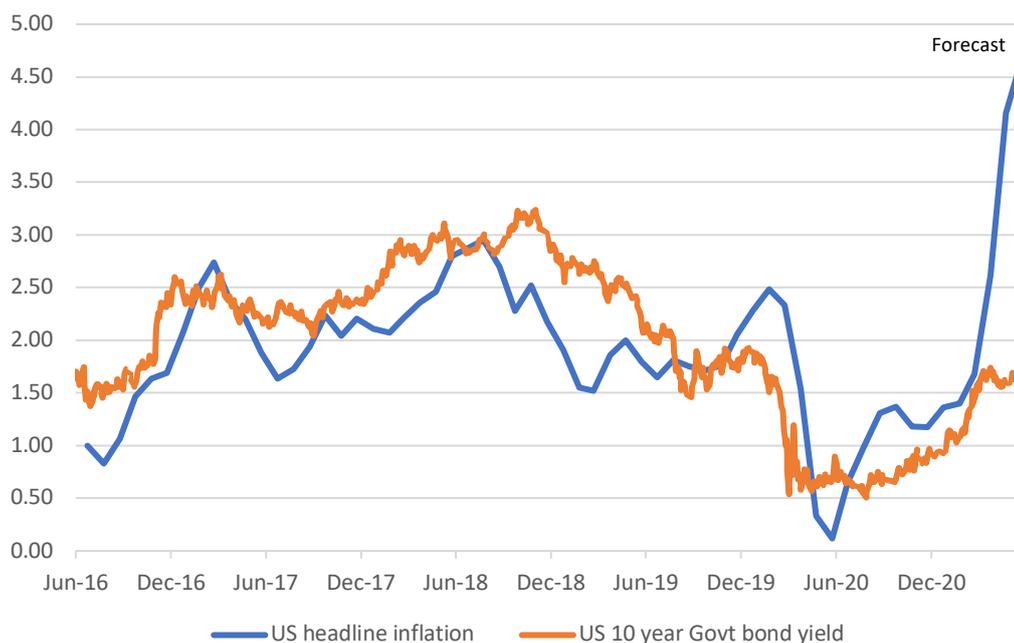
June 7th, 2021

Credit bracing for higher inflation

- US headline inflation due this week; market expects just shy of 5%
- More pipeline inflation in evidence, as parts of the world run short of products and workers
- US year-end inflation forecasts still around 2.5% to 3%.
- We suspect the Fed will have to relent and allow the yield curve to steepen, if only to endorse the inflation, rather than the deflation mindset of the market.
- High yield markets may struggle to provide significant, if any, return, but equally we do not expect any sort of rout.

Credit markets have remained strong despite the evident pick in inflation – the future though could be more challenging. This coming week economists expect US inflation to hit a near 5% level for May. A few months ago, the economists' consensus forecast for the peak in inflation had been no higher than around 3.8%. With inflation likely persisting, the Fed this time will be challenged to respond. Credit markets are on watch.

Chart 1: US headline inflation and US 10-year government bond yield (%)



Source: Bloomberg

We see further pipeline inflation pressures. Around the world, companies are running extremely low levels of inventory relative to the level of orders. It is only a matter of time before this pressure likely translates into higher prices. Companies cannot get hold of either vital components or a product they urgently need to meet demand. Stories abound of the substantial increase in shipping rates due to a shortage of vessels. Bloomberg recently reported that the cost to move goods in a shipping container from Asia to Europe had shot above the \$10,000 level for the first time on record.

As an interesting anecdote on the inflation theme, there are evident shortages of US truck drivers. The US Journal of Commerce reports, "the average weekly hours worked by nonsupervisory employees at trucking firms, including drivers and dock workers, rose to 43.3 hours in April, a new record high after an increase to 43 hours per week in March. That is an hour per week longer than the 41.9-hour average from 2015 through 2019. **Trucking companies are increasing pay, and some carriers have raised their per-mile pay rates more than twice in the past 12 months**".

Last week's US employment report for May showed similar aggregate trends. The average workweek remains elevated at 34.9 hours, and average hourly earnings rose 0.5% for the month, now at a 4.5% annualised pace. However, labour force participation fell another tenth to 61.6%.

With the world facing a resurgence of demand after a lull in April, we will likely see further inflation pressures through the summer. US and euro area retail sales show sharp contractions in April due to continued lockdowns in Europe and the lack of government payouts in the United States in that month.

With evident inflation pressures, attention has turned towards which major central banks will turn hawkish and tighten monetary policy. **Forecasts for year-end US inflation have inched above 3.0%**. And something to ponder over here: economists expect inflation to remain elevated even when some of the most significant impacts of COVID have passed. Such forecasts put increasing pressure on the Fed to do something. Only time will tell if the Fed feels the need to dial down at least some of the extraordinary levels of accommodation it has provided the market.

The European Central Bank (ECB) meets this week where it will discuss the pace of its quantitative easing. The market is anticipating that the ECB will maintain its current monthly purchase pace of around 80 billion euros. However, it is unlikely the ECB will adopt a significant policy shift when inflation, even on its forecasts, is still likely to be significantly below the 2% target. Economists expect the ECB's inflation forecast for 2023 to remain under 1.5%.

Credit investors are bracing for the beginning of a tapering discussion from the Fed in June. We remain of the view that the Fed will have to countenance some rise in long-term interest rates, if only to instil a more pro-inflation mindset into the market. A US 10-year yield of 1.90% before the year end still looks quite possible.

With the long end of the curve still well-behaved (the 10-year yield ended last week at 1.55%), the surge in new issuance continues. By last week, \$47 billion in new high-yield bonds had been priced and issued, the busiest May ever. It was undoubtedly a case of sell/issue in May for corporates, but there is no indication that it will abate. The expectation is that issuance from June onwards will continue to be higher than its historical pace.

The performance of the credit market reflects the dual impact of the liquidity provision that the Fed had provided through the COVID crisis and the very favourable economic backdrop that the broader policy

interventions subsequently have created. Bloomberg reports that the CCC-rated credit bucket, the lowest-rated credit bonds (apart from the ones already in default), is on track to report its 14th straight month of positive absolute returns, the second-best streak ever. The record is 16 months, during the recovery period of the Savings and Loans crisis in the early 1990s.

At the end of May, a lull in issuance saw spreads rally close to the lows for the year. The Bloomberg Barclays US High Yield Index spread to Treasury yields dropped again below 300 basis points (bps), ending last week at 296 bps, compared with the low for the year at 284 bps. **It is tempting to ascribe the recent surge in issuance as a cash grab by corporates to gear up balance sheets while liquidity is plentiful.** However, it is also true that many fixed-income investors still face a dearth of yield and remain willing to commit to the market against a backdrop of strong growth.

History has shown that default rates are modest to low when the economy is growing strongly, and the current episode is no exception. The expected default rate as projected by Moody's is now below 3% for the 12 months from here. That is more or less in line with the historical average for the asset class. However, there appears to be the possibility that the number is still a little on the higher side. JP Morgan's research points out that the actual number of defaults and dollar amount affected is mild. It reports that so far this year, seven companies have defaulted on bonds or loans (for losses of \$3.5 billion), and five have completed distressed exchanges. That constitutes the mildest outcome for defaults and related losses for the first five months of the year since 2011.

With outright yields on high yield bonds in the range of 4.5% to 4.75%, it is to be expected that even if there is some further spread compression from here onwards, the risk of higher underlying yields **makes further gains for this market unlikely.** HY has gained 2.5% in the US and 3.2% in Europe year-to-date to the end of last week.

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