

# Inflation Dynamics: A Shift from Goods to Services

November 2022

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In October, equities across developed markets rallied. The U.S. was the best performer as the S&P 500 Index returned 8.1%<sup>1</sup>. In local currency terms, the MSCI Europe Index and MSCI Japan Index each returned 6.2% and 5.7% respectively<sup>1</sup>. In contrast, the MSCI EM Index (USD) fell 3.1%<sup>1</sup>. The energy sector rallied hard, with the MSCI ACWI Energy Index returning 18.0%<sup>1</sup>, far outperforming the other sectors. While monetary policy continues to tighten, inflation remains broad-based and far too elevated. The U.S. 10-Year yield was pressured higher, ending the month at 4.1%<sup>2</sup> and the VIX peaked at 33.6 in mid-month, before easing somewhat to a level of 25.9 by month-end<sup>3</sup>.



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## **U.S.: From goods to services inflation**

Many expect U.S. inflation to plateau and subsequently fall, as supply chain constraints have eased meaningfully and goods inflation normalises. However, pressure remains elevated in another component of inflation: services. Historically stickier than the more volatile goods component, it may take longer to come down. The services sector is still exhibiting tight labour market conditions, creating wage pressure. In an economy heavily based on services, wage inflation may prove difficult to suppress. However, at the same time, some key categories within the Consumer Price Index (CPI), such as shelter and healthcare, are subject to significant lags. This can make it more challenging to isolate the ongoing impacts of a tight labour market and the lagged effects of the pandemic within the CPI.

### **Notes:**

1. Bloomberg, 1-month returns, total return indices, as of 31 October 2022.
2. Bloomberg, as of 31 October 2022.
3. The VIX spiked to 33.6 on 11 October and ended the month at 25.9.

### **Towards a more insular China**

China's 20th Party Congress held from 16 to 22 October, concluded with President Xi Jinping's re-appointment for a third term. The reshuffle in his executive committee demonstrated that President Xi's top priority is to concentrate power, as his committee predominantly now consists of people who should help further his stronghold. The present-day policy direction is likely to be maintained, with the zero-COVID policy dynamic expected to be in place longer than anticipated. There is an increased emphasis on national security, as opposed to growth and development, along with a further sharpening of focus on Taiwan's reunification with China.

### **Investment implications**

We have maintained a stable allocation to equities throughout the month. We remain cautiously positioned given the headwinds that we continue to see for global markets as they could cause further volatility. We see residual downside to equities, especially with respect to earnings. It is in this context that we made the following tactical changes in October:

#### **China A Equities**

We moved from overweight to neutral in China A equities. We no longer expect China A to outperform global equities, due to a lack of positive catalysts.

#### **UK Gilts**

At the end of October, we reduced our underweight of UK gilts versus European government bonds, as the UK government's policy U-turn and change in leadership reduces the risk of downside.

#### **Short-Dated Mexican and Brazilian Bonds**

For portfolios which permit, we added short-dated Mexican and Brazilian bond exposures. Both Mexico and Brazil are considerably ahead of the U.S. in terms of tightening monetary policy. Consequently, their short-dated bonds offer attractive carry, while we see the potential for FX upside in BRL and MXN in 2023.

#### **Duration and U.S. 10-Year Treasuries**

We moved from underweight to neutral duration on U.S. 10-Year Treasuries. U.S. 10-Year yields had risen significantly since we moved underweight in late August. Since then, the U.S. terminal rate has moved above 5.0%, rate cuts in 2023 have largely been priced out, real yields have moved above the top of our forecast range and financial conditions have re-tightened to YTD highs. The U.S. labour market remains resilient, but other segments of the economy, such as residential and non-residential investment, are showing growing signs of weakness. Moreover, valuations at current levels appear fair. Consequently, we see the risk to yields as more balanced.

#### **Sterling (GBP)**

We moved underweight sterling at the beginning of October, as we believed the fiscal deficit was likely to rise meaningfully following the tax cuts and support to households on energy bills. The twin deficit is at risk of being the highest on record over the next two years.

### Euro (EUR)

We moved from overweight to neutral the euro versus the U.S. dollar. A higher risk premium may need to be applied to the euro, given the structural issues facing the eurozone. Also, we believe that the U.S. dollar’s strength is likely to continue, as long as flows to “safe haven” assets persist. Demand will likely remain high until the U.S. terminal rate peaks and global growth expectations bottom. In addition, we are looking out for catalysts, such as a capitulation in the S&P 500 and signs of the U.S. labour market starting to soften.

The index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. **Past performance is no guarantee of future results. See Disclosure section for index definitions.**

### Tactical Positioning

We have provided our tactical views below:

Asset Class	--	-	=	+	++
<b>Equity</b>					
US		█			
US Energy				█	
US High Dividend			█		
Eurozone		█			
UK			█		
European Energy				█	
European Banks				█	
Japan				█	
Asia ex Japan			█		
Chinese Equities			█	█	
Emerging Markets			█		
Global Growth		█			
Global Infrastructure			█		
Global Property			█		
█ Latest view					
█ Previous view					

  

Asset Class	--	-	=	+	++
<b>Fixed Income</b>					
US IG Credit			█		
EU IG Credit			█		
US High Yield	█				
EU High Yield			█		
EM Sovereign Debt HC			█		
EM Corporate Debt				█	
EM Sovereign Debt LC			█		
US 10-Year Treasuries		█	█		
EU Core and Peripheral Bonds		█			
UK 10-Year Gilts		█			
JGBs		█			
Short-dated Mexican & Brazilian Bonds			█	█	
<b>Commodities</b>					
Gold			█		
<b>Currencies</b>					
Euro			█	█	
JPY			█		
GBP		█	█		

Source: MSIM GBaR team, as of 31 October 2022. For informational purposes and does not constitute an offer or a recommendation to buy or sell any particular security or to adopt any specific investment strategy. The tactical views expressed above are a broad reflection of our team’s views and implementations, expressed for client communication purposes. The information herein does not contend to address the financial objectives, situation or specific needs of any individual investor. The signals represent the GBaR team’s view on each asset class. A negative signal indicates a negative or underweight relative view, a positive signal indicates a positive or overweight relative view. Light blue indicates the tactical view before the change, with dark blue indicating the view as of 31 October 2022.

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**BRL:** Brazilian Real, the currency of Brazil

**China A Shares:** These are shares of companies based in mainland China denominated in Renminbi and traded in the Shanghai and Shenzhen stock exchanges. They are available to purchase by qualified foreign institutions, where historically they were only available to investors in mainland China.

**Consumer Price Index:** The Consumer Price Index (CPI) is a measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food and medical care. The CPI is calculated by taking price changes for each item in the predetermined basket of goods and averaging them; the goods are weighted according to their importance. Changes in CPI are used to assess price changes associated with the cost of living.

**MXN:** Mexican Peso, the currency of Mexico.

**MSCI Emerging Markets Index:** The MSCI Emerging Markets Index (MSCI EM) is a free float-adjusted market capitalization weighted index that is designed to measure equity market performance of emerging markets.

**MSCI ACWI Energy Index** includes large and mid cap securities across 23 Developed Markets (DM) and 27 Emerging Markets (EM) countries\*. All securities in the index are classified in the Energy as per the Global Industry Classification Standard (GICS®).

**MSCI Europe Index:** The MSCI Europe Index captures large and mid-cap representation across 15 developed markets (DM) countries in Europe.

**MSCI Japan Index:** The MSCI Japan Index is designed to measure the performance of the large and mid-cap segments of the Japanese market.

**S&P 500 Index:** The Standard & Poor's (S&P) 500 Index tracks the performance of 500 widely held, large-capitalization U.S. stocks.

**VIX®:** This is a trademarked ticker symbol for the Chicago Board Options Exchange Market Volatility Index, a popular measure of the implied volatility of S&P 500 Index options. Often referred to as the fear index or the fear gauge, it represents one measure of the market's expectation of stock market volatility over the next 30-day period.

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