BEA 東亞銀行

Economic Research

June 2021

Market Monitor – United States

Stock Market Sees Volatility due to Inflation

Inflation accelerates further in April but jobs growth slows

The headline consumer price index (CPI) rose 4.2% year-on-year in April, while the core CPI rose 3.0%, both beating market expectations. April's accelerating inflation was mainly due to a 25.1% growth in energy prices as a result of the base effect. Meanwhile, the global microchip shortage slowed the production of new cars and contributed to a price surge in used cars.

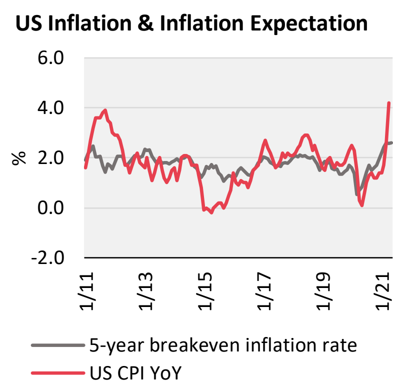
Despite the falling number of new Covid-19 cases and an ongoing relaxation of business restrictions, jobs growth slowed significantly in April. Nonfarm payrolls only rose by 266,000 jobs in April, far below the market expectation of 1 million new jobs. Non-farm jobs were still down by 8.2 million from their pre-pandemic level of February 2020. At the same time, the unemployment rate also rose slightly to 6.1%, up from 6.0% in the previous month. However, retailers and restaurant operators have been facing a huge labour crunch, with Under Armour raising wages for hourly retail workers to USD 15, and McDonald's raising hourly wages by about 10% on average. High unemployment benefits are partially blamed for the manpower shortage.

Although Federal Reserve (Fed) officials generally reckoned that the current surge in inflation momentum is transitory, the April meeting minutes reveal that several participants said it might be appropriate at some point in upcoming meetings to begin discussing a plan for adjusting the pace of asset purchases, as long as the economy continued to make rapid progress toward the committee's goals.

Going forward, as reopening progresses and consumer demand rebounds, inflationary pressure will intensify. If the disruption in supply chains is prolonged, inflation may pick up faster in the longer run. For example, although current market expectation is that the US annual CPI growth will ease to 2.3% in 2022, down from 3.0% in 2021, the bond market has been factoring in higher inflation over the next few years. The 5-year breakeven

- **April CPI reading beats market expectation.**
- **Stock market sees volatility as markets fear the Fed may taper off asset purchases earlier.**
- **US dollar continues to weaken as low interest rates are expected to remain in place in the short run despite higher inflation.**

US Inflation & Inflation Expectation



Source: Bloomberg, data as of 28/5/2021

inflation rate, which is calculated as the difference between the yield of a nominal Treasury and the yield of a Treasury Inflation-Protected Securities (TIPS) with a similar maturity, stood at 2.595% as of 28th May, implying that market participants expect inflation to average at a similar level for the next five years. The higher inflation expectation may prompt the Fed to reverse its monetary policy earlier than expected.

Equity market sees volatility as inflation concerns intensify

The higher than expected inflation reading triggered concern that people's purchasing power could be crippled, potentially prompting the Fed to begin tapering off its asset purchase programme and raising interest rates before the economy fully recovers. Higher interest rates will likely have the effect of cooling returns in the equity market, especially from tech stocks, where exacerbated falls have been seen recently due to the large price volatilities of cryptocurrencies. On 12th May, Nasdaq, S&P 500 index and Dow Jones Industrial Average recorded drop of 6.7%, 2.8% and 0.8%, respectively, when compared to the level at the end of April. As of 28st May, the Nasdaq still had registered a 1.5% drop when compared to the level at the end of April. The S&P 500 index saw a 0.5% rise, while the Dow Jones Industrial Average recorded a 1.9% rise over the same horizon.

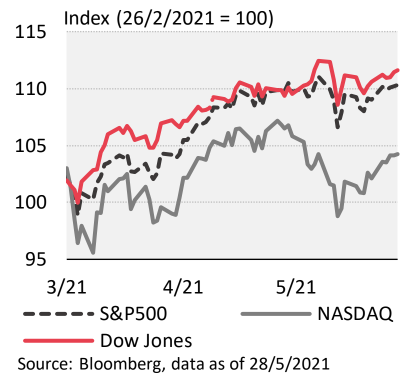
Treasury yields see volatile movement, but US dollar continues to weaken

The 10-year treasury yield was driven below 1.60% in early May as jobs market data disappointed the market. Although treasury yields rebounded after the April CPI reading beat market expectations, the 10-year treasury yield stood at 1.596% as of 28th May, about 3 basis point lower than the level at the end of April.

Key Fed officials have insisted that the current inflation rate is transitory and that low interest rates are expected for some time. Market participants are worried that ongoing inflation will erode the value of the US dollar. As of 28th May, the dollar index had dropped by 1.4% from its level at the end of April.

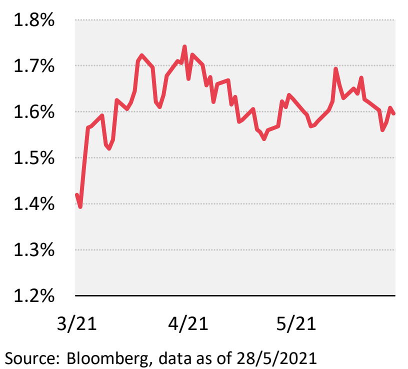
Looking ahead, Biden has recently proposed a USD 6 trillion budget for fiscal year 2022, which includes American Jobs Plan and American Families that may involve spending of about USD 4 trillion over the next 8 to 10 years, with some of the spending expected to be financed by increasing the government debt. The debt to GDP ratio is projected to rise to 117% by 2031 the level of about 100% in 2020. This will push up treasury yields. Higher funding costs may pose a risk to the corporate earnings outlook, and elevated asset prices will come under pressure from higher discount rates.

US Equity Indices



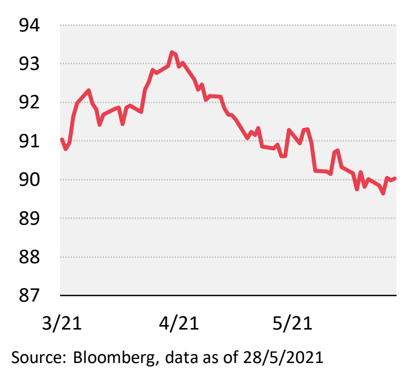
Source: Bloomberg, data as of 28/5/2021

US 10-year Treasury Yield



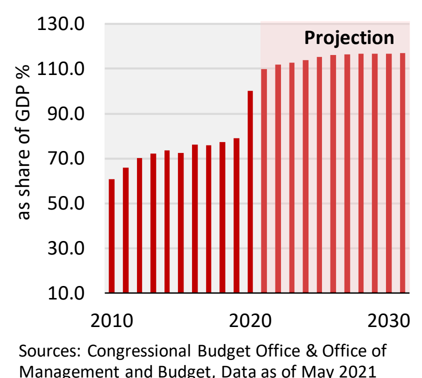
Source: Bloomberg, data as of 28/5/2021

Dollar Index



Source: Bloomberg, data as of 28/5/2021

Federal Debt held by Public



Sources: Congressional Budget Office & Office of Management and Budget, Data as of May 2021

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