A New Inflation Regime

LATEST

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Federal Reserve Chairman Jerome Powell

Investors monitor bond yields

Last week, it was noted that while the conditions were in place for a strong economic recovery and that the easy gains had been made, the economy would need to see new developments on COVID-19 vaccines and therapeutics in order to close the remaining gap to pre-pandemic economic levels. On this front, there were three pieces of good news – which contributed to the favourable tone in global equity markets this week, up roughly 2%.

Firstly, on Sunday 23rdthe FDA announced it was approving convalescent blood plasma procedures for emergency use. Secondly, Moderna delivered encouraging data on the efficacy of its potential vaccine in older patients.

Test Test Test

The big news, however, came on Wednesday 26thwith the announcement from Abbott Laboratories. The company confirmed it had received emergency authorisation for a $5 coronavirus test that yields results in 15 minutes without requiring any laboratory equipment. Jim Cramer, the television presenter and former hedge fund trader, tweeted:

"I think this is the big one. First large scale test that can make us be able to travel, go to work, test, test, test without the maddening delay. I am calling it big."

Abbott Labs' share price rose 8% the following day.

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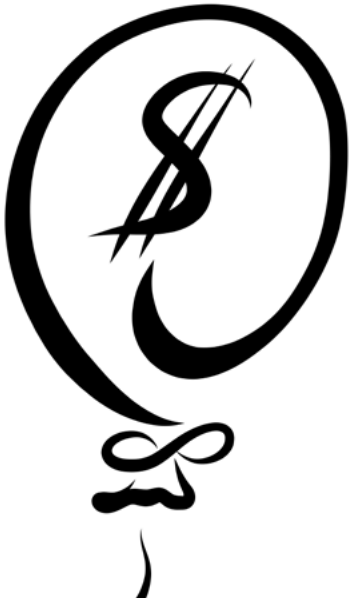
New inflation regime

Another major event was the much anticipated speech by Federal Reserve Chairman Jerome Powell at the Jackson Hole Symposium on Thursday 27th. The Fed signalled its willingness to tolerate higher inflation in pursuit of its overall policy goals – its way of aiming for a stronger labour market.



The existing approach to monetary policy operates under the premise that there is some tension between robust job gains and stable prices. If things were to get too good for workers, then prices might suddenly start going up – ordinarily requiring rate hikes to slow things down. By tolerating higher inflation, the Fed is signalling that the next time the labour market gets strong, they'll hold off for longer than they otherwise would have before hiking rates.

This new inflation regime should be positive for risk assets. The content of Chair Powell's speech, however, had been widely flagged so this came as no surprise to the market. Instead, the speech was more noteworthy for what it had omitted. Some market participants may have been surprised by the fact that yield caps and targets were not added to the Fed's toolkit – one such explanation for the violent rise in bond yields after the speech.

Investors should monitor bond yields closely as many analysts justify the current high equity market valuations by pointing to low bond yields. Indeed, there are some signs of froth emerging. For example, shares in Chinese electric vehicle maker Xpeng Motors soared more than 40% on its New York debut after its IPO. However, with the economy recovering and good news on COVID-19, there is a case to be made for continuing to hold equities.