US inflation stress test awaits skittish markets this week

Andrew Macken says equities got to a point that was unsustainable. **Peter Rae**

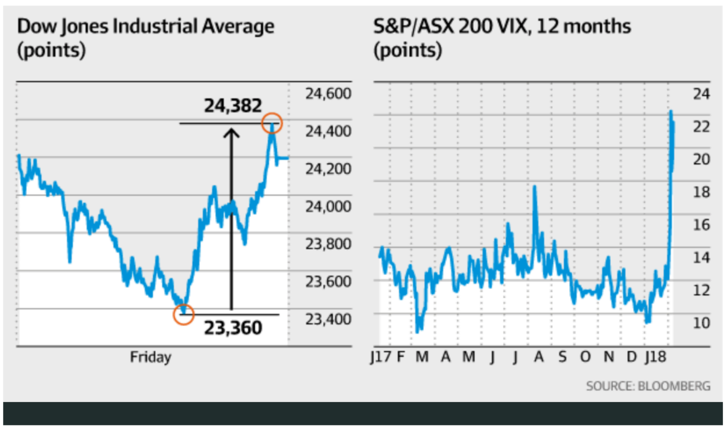
by Vesna Poljak

Equity market nerves will be tested again this week when the first US inflation print of the year is released, after a flash of heat in wages 10 days ago caused a Wall Street correction and unleashed volatility at a ferocity unseen since 2015.

Another rocky session for the US market on Friday sets Australian shares up for a 28-point or 0.5 per cent fall when trading resumes on Monday. The Dow Jones Industrial Average traded in a 1000-point range before closing at 24,190 points for a gain of 1.38 per cent.

Forecasters are looking for a 0.2 per cent month-on-month and 1.7 per cent year-on-year rise in the core consumer price index when it is released on Wednesday in the US (or 12.30 AEDT on Thursday.)

Andrew Macken, portfolio manager at Montgomery Global Investment Management, says the events of the past week have "shattered the dreams of many investors that were used to stocks only going up".



"Nobody can predict when these fairly sharp market movements will happen, but they shouldn't really be surprising especially after the month of January where the MSCI was up 5.3 per cent. If this were repeated for 12 consecutive months, the total return for the year would exceed 85 per cent. That rate of appreciation is extraordinarily high and absolutely unsustainable if we're being honest."

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The positive end to the week for the Dow masked what was another day of high volatility. It is not just investors in the US that are experiencing a rollercoaster ride. The A-Vix, or S&P/ASX 200 VIX, is at 21.5, almost double its 12.2 average of the past 12 months. The MSCI World Index had its strongest month in almost two years, in US dollar terms, when it rose for a fifth consecutive month in January. It was positive in 14 of the past 15 months.

After the S&P/ASX 200 Index closed at 5838 points on Friday, Australian shares have fallen 4.85 per cent since their peak in January, and are down 3.75 per cent year-to-date back to October 2017 levels. US, Japanese and Chinese equities entered correction territory last week, meaning they have fallen 10 per cent from their highs.

The Australian dollar is fetching US78.13¢ and the 10-year Australian government bond yield settled at 2.862 per cent. The spread between the Australian and US 10-year bonds is less than 2 basis points and appears destined to turn negative for the first time in 18 years.

The upcoming US Bureau of Labor Statistics release comes off a 0.1 per cent increase for December, seasonally adjusted; all items less food and energy (the core measure) increased 0.3 per cent that month, the largest increase since January 2017. Apparel fell and prescription drugs rose.

WEEK AHEAD

MONDAY	TUESDAY	WEDNESDAY	THURSDAY	FRIDAY
Amcor, Ansell, JB Hi-Fi	Challenger, GPT	Computershare, CSL, IAG	ASX, Healthscope, Origin, South32, Telstra	Medibank, Star Entertainment, IOOF, Primary Health
NZ Jan retail card spend	RBA's Ellis speaking	Feb Westpac-MI consumer sentiment,	Aust Jan jobs data	RBA's Lowe testimony
US Jan budget statement	UK Jan CPI	Japan 4Q GDP	US Jan PPI and industrial production	UK Jan retail sales
		US Jan CPI		US Jan import prices

SOURCE: CITI, WESTPAC

Westpac sees core inflation stable at 0.2 per cent but fuel could push the headline figure to 0.4 per cent (consensus is 0.3 per cent for the monthly figure and 1.9 per cent annual).

"Where things could get interesting is if we do see a surprise to the upside in the US inflation data. If that happens then expectations for the rate of interest rate hikes, the steepness, will increase more quickly," Mr Macken said.

"If that happens, then we could see outflows from equity and inflows into bonds believe it or not. There are plenty of institutional investors out there such as pension funds and others who have been forced out of bonds and into equities over the last eight or nine years and who would be delighted to go back into bonds if they could get another 100 basis points of yield," the fund manager said.

"We're in this funny world where the last week really proved this. You can have a situation where fundamentals are absolutely improving and yet stock prices fall. Stock prices not only expected the improvement we're seeing, but stock prices expected even more than what's being achieved," Mr Macken concluded.


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Other inflation data this week comes on Tuesday from the UK, where annual inflation has been running above 3 per cent since October 2017, and on Wednesday out of New Zealand, where quarterly inflation expectations are due. The January US producer price index follows on Thursday.

Capital Economics declined to play down the US market correction as just a "blip" and expresses concerns the budget deal reached in Congress is good for equities in the medium-to-long term.

"The risk now is that inflation will rise more sharply, as a result of even looser fiscal policy. This could endanger the economic recovery by necessitating even tighter monetary policy," Capital's chief markets economist John Higgins writes, predicting a "sizeable monthly gain in core CPI" this week.

On the flipside, a disappointment on the CPI "would be enough to stall the rout, given that markets are now in panic mode", Daniel Been, ANZ currency strategist, said. He deemed the hurdle to disappointment high because market expectations are so low.