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ASSET MANAGEMENT

“Inflationary Boom”: In this article Westminster Asset Management Investment Strategist, Peter Lucas, considers the outlook for the major asset classes based on our quantitative models.

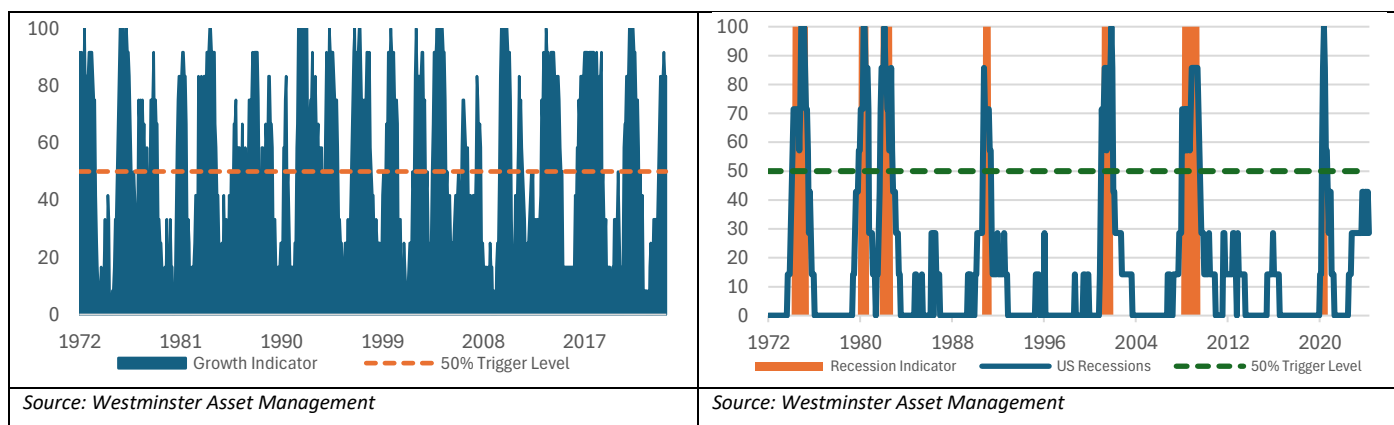


My last strategy article was in January. My focus was the bond market which had enjoyed a decent two-month recovery, as I predicted late last year (“Strategy Update”, October 2023). I said that valuations and investor sentiment indicated that a great deal had already been discounted, and that a period of range-trading was the best we could hope for, at least in the short term.

Since then, bond yields have largely tracked sideways, except in Japan where yields have risen back to their 2023 high. If anything, when you consider the unbridled optimism of investors at the start of the year and the disappointing inflation news since then, it is a bit of a surprise that bonds haven’t sold off more.

Meanwhile, equities and commodities have performed well, buoyed by fading recession fears and more recently, by optimism that China may be turning the corner. It is notable that the price of gold has risen despite investor disinterest (falling number of outstanding ETF shares), rising bond yields, and dollar strength, due to significant purchases by price-insensitive global central banks.

On the face of it, the environment for bonds remains tricky. My US inflation and growth models are both in ‘accelerating’ mode, a fertile environment for commodities. Recession risk is non-zero but unsurprisingly given the accelerating growth signal, has moderated, and moved further away from the trigger threshold. The deceleration in inflation since 2022 has not been sufficient to flip the inflation trend indicators and we remain in a ‘rising inflation’ environment. The bottom line is that the fundamental evidence points to an ‘inflationary boom’ which favours commodities over bonds and to a lesser extent, equities. Another headwind for equities comes in the shape of extreme investor optimism, which is generally associated with negative short-term equity returns.



Indeed, with commodities and inflation bottoming out, the best hope for bonds is a loss of confidence in the equity markets. Some central banks have already cut rates, and many others are inching in the same direction – a bit of stock market volatility might be enough to push them over the edge. In the medium/long term, my suspicion is that any such easing will merely serve to cement the incipient turn in inflation.

The bottom line is that equities need to be approached with caution in the very near term, the outlook for commodities is looking better and better, and any short-term strength in government bonds should be used to trim exposure and/or duration for the expected sell-off later this year.

Peter Lucas – May 2024

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