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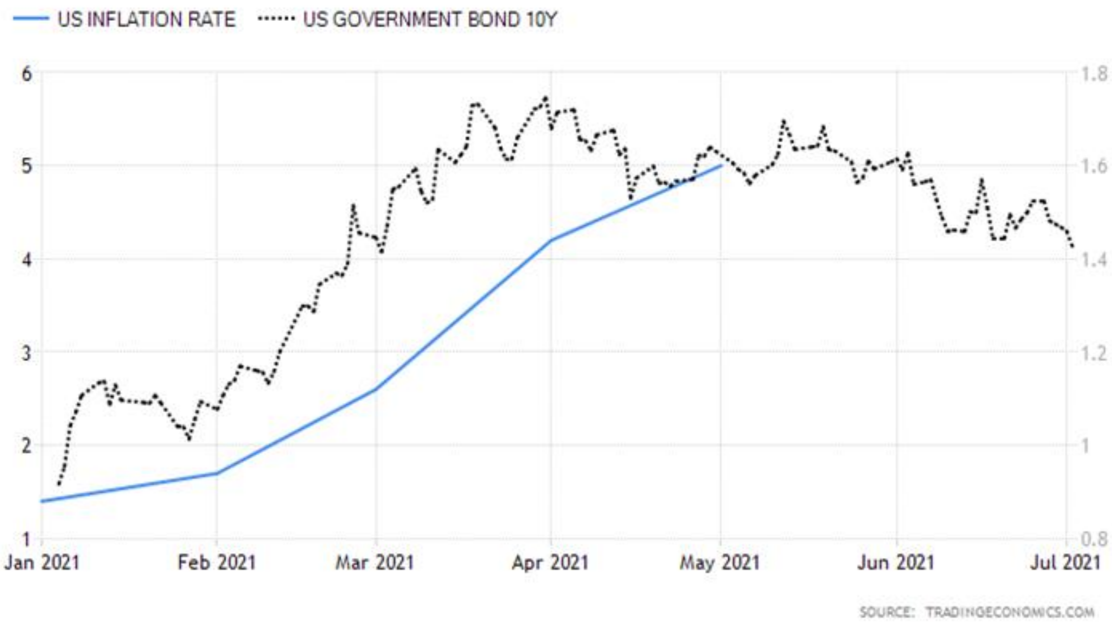
When Bond Markets Stop Caring

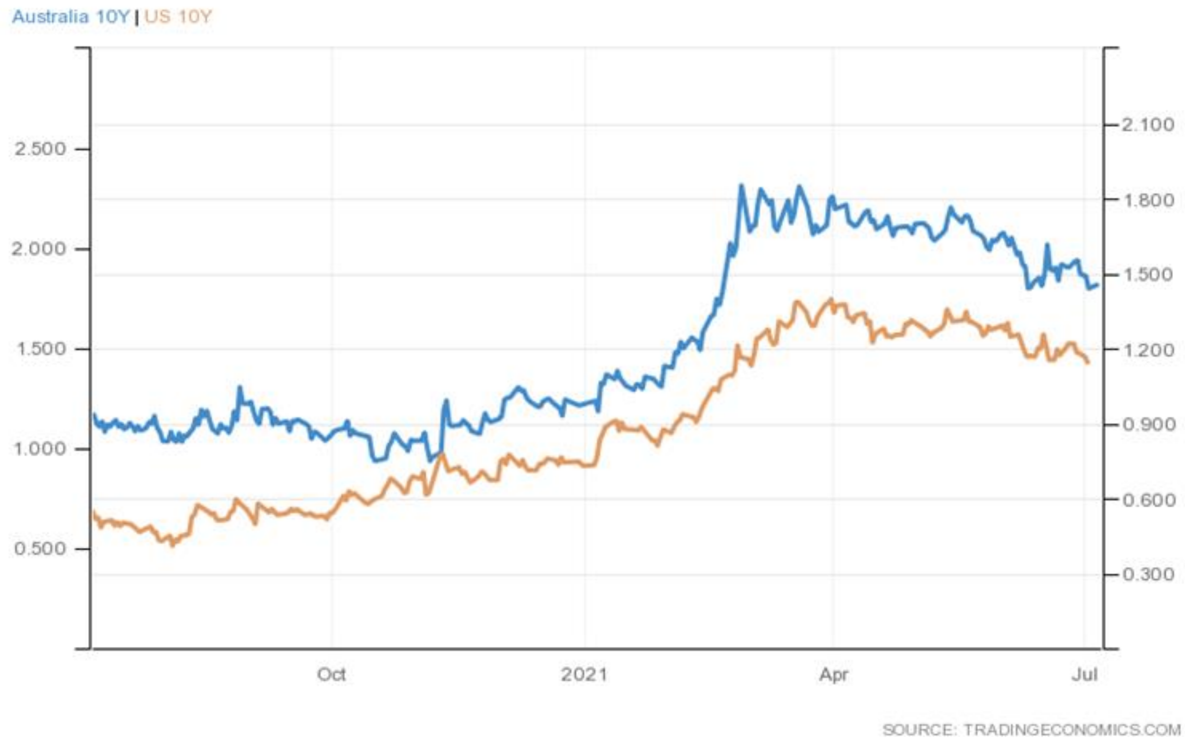
For centuries, the cost of money has been a function of inflation – "safe" government bonds have typically compensated investors for the expected loss of real purchasing power. But in 2021, inflation is completely ignored. This is perhaps the most bizarre of all the unprecedented events investors have encountered.

Our monthly ***Fixed Interest Analysis*** paper often talks about inflation. But it became clear in 2021's massive US inflation spike that **inflation is actually irrelevant to fixed interest.** This is contrasted to previous inflation shocks, which brought huge bond movements, and we encourage readers to read our analysis.

Here is US inflation shooting from 1 ½% to 5% in a few months. And as this data emerged (with a lag), the worst data in 30 years actually saw bonds rally. Sure, markets had expected a high headline number as the COVID19 deflation rolled out. But 3½% was baked in and included in consensus – not 5%!



So, what does drive bond markets? At the risk of a circular answer: ***Other bond markets***!



Why would a bond market stop caring about inflation?

Because central bankers have stopped caring. As we covered in our paper elsewhere, in the old days when inflation rose central banks asserted their inflation-fighting credentials by squashing that inflation. Interest rates rose with inflation, or before inflation.

They did this because **"credibility" had value**. If investors did not believe central banks would keep inflation low, they demanded higher returns to invest. The cost of money became cripplingly high, hurting investment and employment. **Higher rates sometimes brought lower rates the rest of the time.**

Today, we have a central bank doing nothing about soaring inflation. **They declared it "transitory."** *Roma locuta, causa finita est*.

The last "old style" central banker was the ECB's Trichet, who reacted to post-GFC inflation with a series of rate increases while the recovery was still fragile. Europe was plunged into a double-dip recession, peripheral Europe faced insolvency, and the banks were deeply troubled.

Ultimately, Trichet was wrong – inflation was transitory that time. The ECB spent much of the decade fighting *deflation* risks.

But credibility is still important. After the GFC, European crisis and COVID19, **investors care about a central bank's credibility in fighting deflation**. Virtually no one remembers high inflation, and inflation has not been the major threat to wealth. ***Until now.***

Leading Markets

The US Dow Jones, S&P500 and NASDAQ closed +0.02%, +2.3% and +5.6% respectively. The rest of the world traded slightly higher - MSCI World ex-AUS gained +2.4% in local terms. Emerging Markets gained +0.2% in $US with Frontier +2.7%.

US 10-year bonds rallied to 1.45% (-13bp). High yield set a post-GFC record, closing at +304bp (-30bp).

Other Highlights

COVID19 deaths approach 4m (+¼m) from 182m cases (+10m), both increases roughly halving *vs* May. US deaths fell ~95% from the January high; UK by >99%. Israel went from 75 deaths a day to 1 since June 12th.

70% take-up appears possible in adults, although there are questions about herd immunity when not vaccinating children.

G7 met in the UK, concluding with a weak anti-China resolution, global vaccine donations, higher taxes and a path to carbon tariffs.

Chinese and US foreign ministers spoke again, with Taiwan tensions escalating.

Bitcoin fell 50% from April's high.

GDPNow guides +8.3% p.a. for Q2 growth after a series of downgrades.

US unemployment fell to 5.8% (-0.3%) in May, after Non-farm Payrolls doubled to +599k. Youth unemployment was 9.9% (-1.1%). Inflation soared to +5% YoY (from +4.2%%) after a +0.6% month, a probable peak exceeded only once since 1991. Core inflation was +3.8% *vs* +3% in April, a 30-year high.

Retail sales slipped -1.3% in May, following a +10% jump of March.

Eurozone unemployment improved to 7.9% (-0.1%). Prices rose +0.3% in June, same as last month. Core inflation rose to +0.9% YoY (-0.1%).

China's prices fell -0.2% in May to be +1.3% YoY.

Japan had its 4th positive CPI (+0.3%) in the past 5 months, to be -0.1% YoY. Retail sales eased -0.4% as GDP fell -1% (revised from -1.3%).

Domestic

The RBA again affirmed existing policy settings. The "*2024 at the earliest*" wordings remain in each statement. The July meeting is likely to keep the 10bp rate peg at the shorter April 2024 bond. Bond purchases may be extended.

The TFF bank funding scheme ends June, with banks having to pay market rates thereafter.

The month closed with ~30% first or second COVID19 shot but further concern about the locally made AstraZeneca. Another round of lockdowns followed uncontained a "delta" outbreak.

The ASX200 gained +2.3% and the Small Ordinaries +3.1%, with the ASX200 reaching 7300 and 7400 for the first time.

Household wealth rose +$½tr to a record $12.7tr ($492k *per capita*), mostly housing as the ABS reported +5.4% residential growth in Q1. CoreLogic reported an even stronger +6.2% for Q2.

10-year bonds were stronger at 1.5% (-12bp).

The national vehicle fleet reached 20M, ageing to 10.6 years.

May unemployment fell -0.4% to 5.1% despite record 66.2% participation, on a massive +115k jobs (85% fulltime). Underemployment also plunged -0.4% to 7.8% (a 7-year low). Labour shortages are emerging in some regions and industries, with 27% finding difficulty filling jobs. Employment and GDP are both exceeding pre-COVID peaks.

Goods trade had a record +13.3bn surplus, on record exports. Retail sales grew +0.1% in May.

April dwelling approvals fell -8.6%, mostly in apartments.

Commodities and Currency

WTI oil hit a multi-year high, reaching $US74.6/bbl (+10%). Gold fell to $1775/oz (-7%). Iron ore rose to $215/t (+6%).

Base metals mixed. Nickel (+3.6%), Aluminium (+4.9%) gained with Tin flat; Copper (-7.6%) and Zinc (-3.1%) fell.

The $A closed at US75.18c (-3%).

KEY FINANCIAL MARKET DATA – AS AT 30TH JUNE 2021 (UNLESS SPECIFIED)

Interest Rate Markets

Index Performance	1 month	3 months	6 months	1 year	2 year p.a.	3 year p.a.	5 year p.a.
AustBond Bank Bill Index	0.00%	0.01%	0.01%	0.06%	0.45%	0.96%	1.29%

Key Rates	Jun-21	May-21	Apr-21
Australian Cash Rate	0.10%	0.10%	0.10%
90 day BBSW	0.03%	0.04%	0.04%
3 Yr Commonwealth Bonds	0.20%	0.10%	0.10%
10 Yr Commonwealth Bonds	1.49%	1.65%	1.65%
CDX North American 5 Yr CDS	48bp	50bp	51bp
iTraxx Europe 5 Yr CDS	46bp	50bp	51bp
iTraxx Australia 5 Yr CDS	58bp	60bp	61bp
US Fed Funds Rate	0-0.25%	0-0.25%	0-0.25%
US 10 Yr Bond Rate	1.45%	1.58%	1.65%

Equity Markets

Domestic	1 month	3 months	6 months	1 year	2 year p.a.	3 year p.a.	5 year p.a.
S&P/ASX 200 Acc. Index	2.26%	8.29%	12.90%	27.80%	8.62%	9.59%	11.16%
S&P/ASX Small Ord Acc. Index	3.08%	8.50%	10.76%	33.23%	12.10%	8.60%	11.24%
S&P/ASX 200 A-REIT Acc. Index	5.54%	10.46%	9.94%	33.24%	2.38%	7.74%	5.79%

International	1 month	3 months	6 months	1 year	2 year p.a.	3 year p.a.	5 year p.a.
US: S&P 500 ($US)	2.33%	8.55%	15.25%	40.79%	23.03%	18.67%	17.65%
US: NASDAQ ($US)	5.55%	9.68%	12.92%	45.23%	35.78%	25.72%	25.80%
MSCI World Acc. (Local Currency)	2.34%	7.58%	14.19%	36.89%	18.91%	14.70%	14.73%
MSCI World Acc. (AUD)	4.64%	9.31%	16.19%	27.52%	15.61%	14.38%	14.64%
FTSE 100 (£)	0.41%	5.66%	10.91%	18.01%	0.86%	1.09%	5.60%
MSCI Emerging Markets ($US)	0.17%	5.05%	7.45%	40.90%	16.68%	11.27%	13.03%

Fixed Interest Markets

Bonds	1 month	3 months	6 months	1 year	2 year p.a.	3 year p.a.	5 year p.a.
BarCap Global Agg Acc. (Hgd AUD)	0.49%	0.94%	-1.61%	-0.17%	2.47%	4.03%	2.87%
AusBond Composite Bond Acc.	0.69%	1.52%	-1.74%	-0.84%	1.64%	4.22%	3.19%
ICE BoAML High Yield TR ($US)	1.37%	2.77%	3.70%	15.62%	6.94%	7.15%	7.30%

Data*	Current Period		Previous Period	
Employment Data				
Employment Growth	May	115,200	April	-30,600
Unemployment Rate	May	5.10%	April	5.50%
Participation Rate	May	66.20%	April	65.90%
Lending Finance				
Housing Finance	May	4.90%	April	3.70%
Personal Finance	May	5.60%	April	4.80%
Business Finance	May	-0.50%	April	-10.50%
Other				
Balance on goods and services	May	9,681m	April	8,028m
Retail Sales	May	0.40%	April	1.10%
Building Approvals	May	-7.10%	April	-8.60%

*All data is seasonally-adjusted.

Median Fund Manager Returns (Morningstar)	**1 month**	**3 month**	**6 month**	**1 year**	**2 year p.a.**	**3 year p.a.**	**5 year p.a.**
Australian Equity Large Cap	1.80%	7.62%	13.17%	29.69%	8.87%	8.04%	9.92%
Australian Equity Small Cap	2.65%	8.66%	11.83%	37.97%	15.34%	9.73%	11.18%
Global Equity Large Cap	3.64%	8.18%	16.22%	28.59%	14.63%	12.59%	13.65%
Global Equity Small Cap	3.91%	8.51%	18.29%	39.73%	17.98%	12.15%	13.66%
Australian Fixed Income	0.67%	1.49%	-1.80%	-0.29%	1.65%	3.96%	2.94%
Global Fixed Income	0.52%	0.93%	-1.77%	0.44%	2.21%	3.60%	2.51%
Australian Listed Property	5.24%	10.34%	9.79%	32.88%	2.21%	7.42%	5.49%
Australian Cash	0.01%	0.02%	0.05%	0.17%	0.54%	0.84%	1.14%
Conservative[1]	0.58%	1.91%	1.07%	4.05%	2.15%	3.22%	3.10%
Moderate[2]	0.99%	3.02%	3.49%	8.21%	4.13%	4.54%	4.36%
Balanced[3]	1.44%	4.33%	6.75%	14.43%	6.20%	6.16%	6.21%
Growth[4]	1.88%	5.71%	9.28%	19.94%	7.99%	7.54%	7.97%
Aggressive[5]	2.39%	7.09%	12.74%	26.46%	10.07%	9.25%	10.22%

[1] Growth Assets 0-20%
[2] Growth Assets 21-40%
[3] Growth Assets 41-60%
[4] Growth Assets 61-80%
[5] Growth Assets 80%+

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