RUBRICS

Transitory or Prolonged?

Fixed Income Macro View

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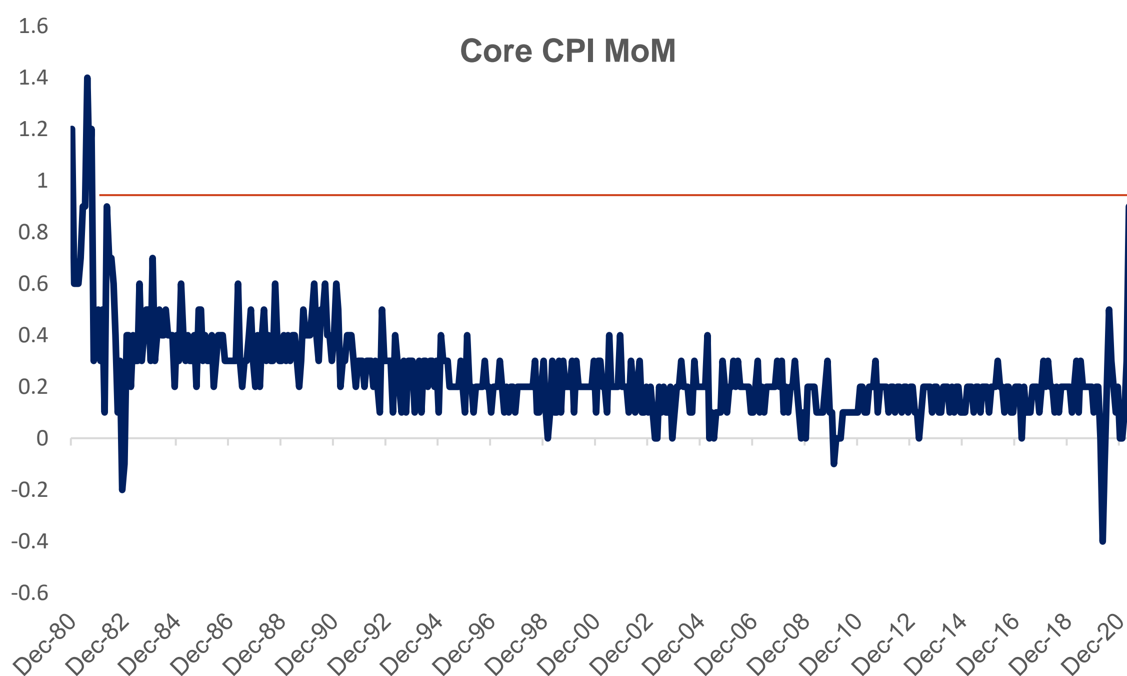
Introduction

Another day another economic data surprise. This time one of the highest inflation readings in decades - MoM core CPI delivered a >4 std dev upside surprise. The talking heads at the Federal Reserve were quick to point out the transitory factors and base effects that heavily influenced the outsized numbers. Nevertheless central bank credibility is on the line here. Overshooting the 2 percent inflation target is one thing, overshooting 4 percent is something else completely. At the moment the bond market is relatively relaxed about the data, but how long can that last if we continue to see upside inflation surprises over the next 3 to 4 months.

All about the Base?

There has been a lot of chatter of base effects given the collapse in economic activity witnessed this time last year. However, a closer look at the data tells us that this does not account for the extremity in recent activity. Much of the sharp move higher occurred in the month on month readings, for which April 2020 lows are irrelevant.

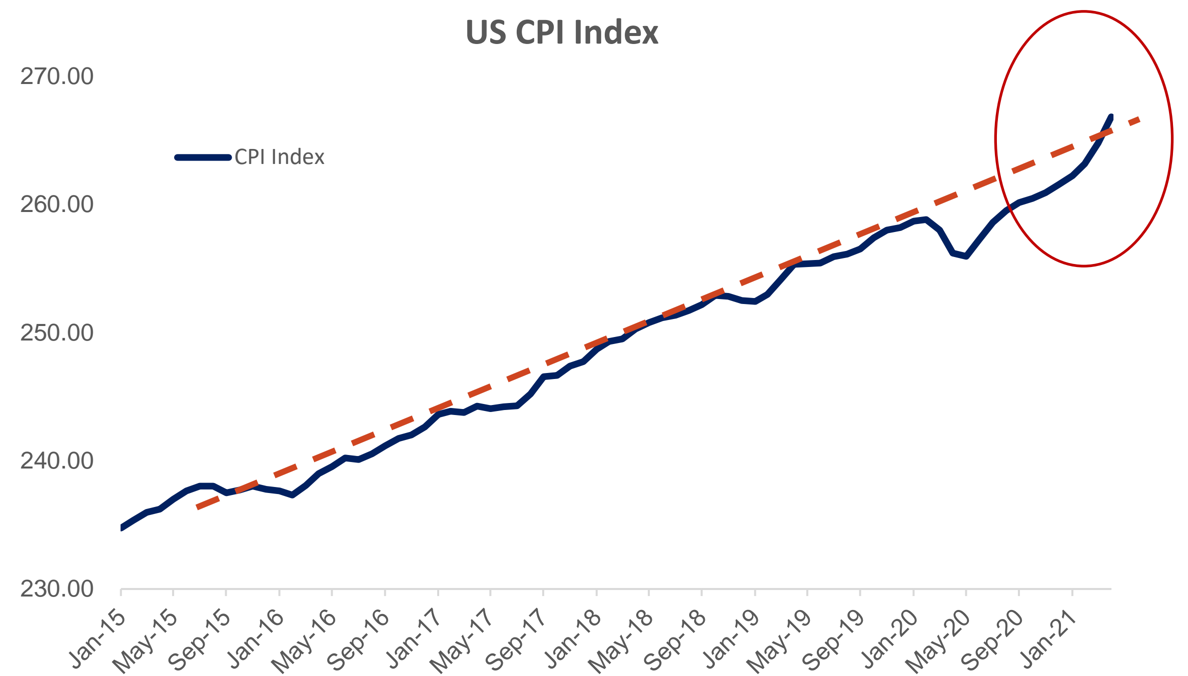
Month on Month Core CPI



Source: Bloomberg as at 13/05/21

The same point can also be gleaned from examination of the longer term chart and the fact that CPI has now resurfaced above the pre-existing trend.

US Core CPI Long Term Trend

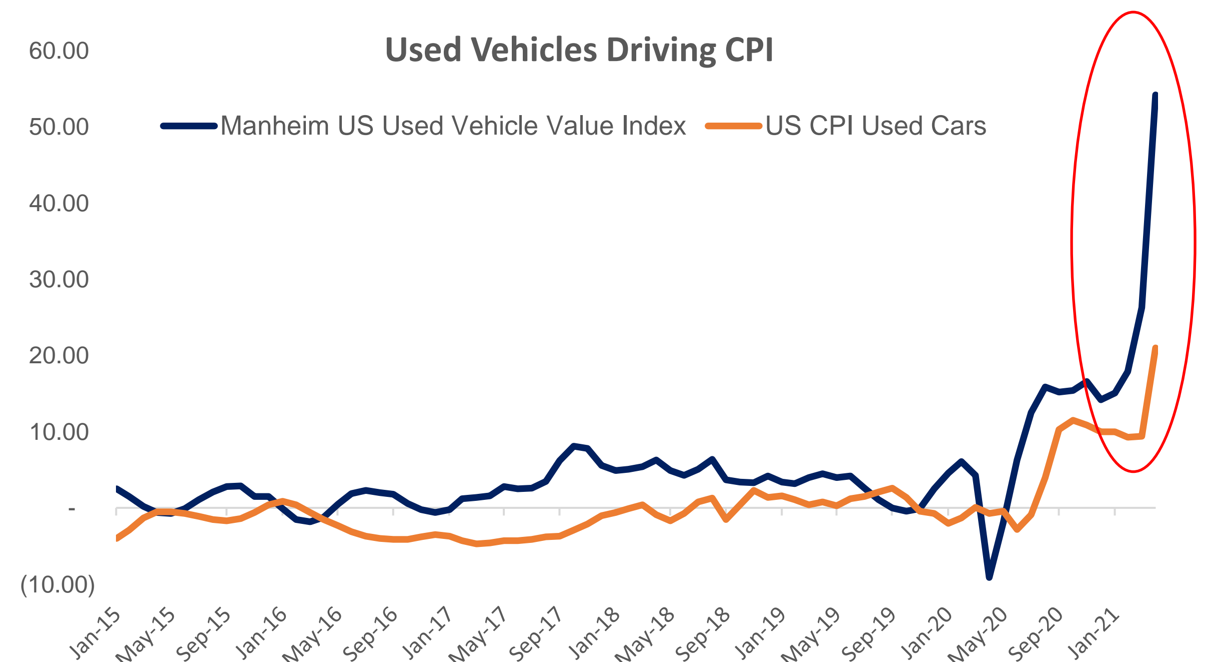


Source: Bloomberg as at 13/05/21

Driving Force

The MoM print for used autos was the highest since 1953. While the much publicised chip shortage in auto manufacturing is undoubtedly a root cause, the price squeeze in the near term shows no signs of abating. On the flip side, subdued rental prices have acted as a drag on CPI since the onset of the pandemic. Given their historical tendency to lag house prices, can we see an uptick in rents in the months ahead?

Used Vehicles CPI vs Used Vehicle Index

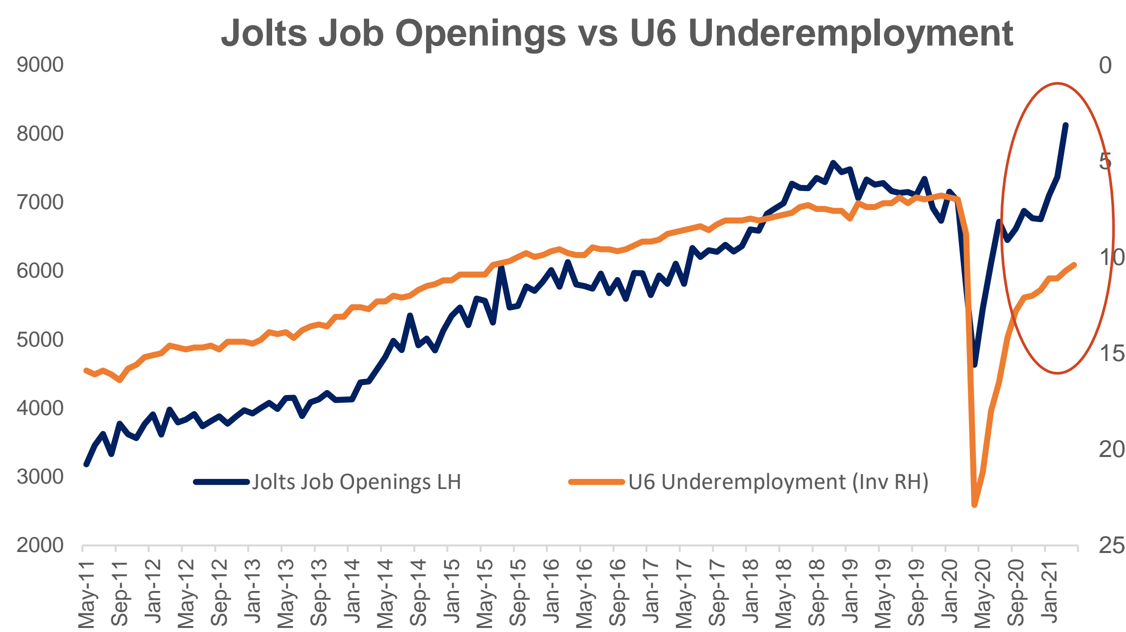


Source: Bloomberg as at 13/05/21

Wages

Wage growth has the potential to continue to rise. Current stimulus packages amongst other Covid related issues can keep the supply and demand of labour out of equilibrium and wage pressures heightened until at least September. Without sustained wage growth however, any inflationary spikes will be met with a drop in aggregate demand (excluding further ongoing fiscal transfers).

Dichotomy between Job Openings and Underemployment

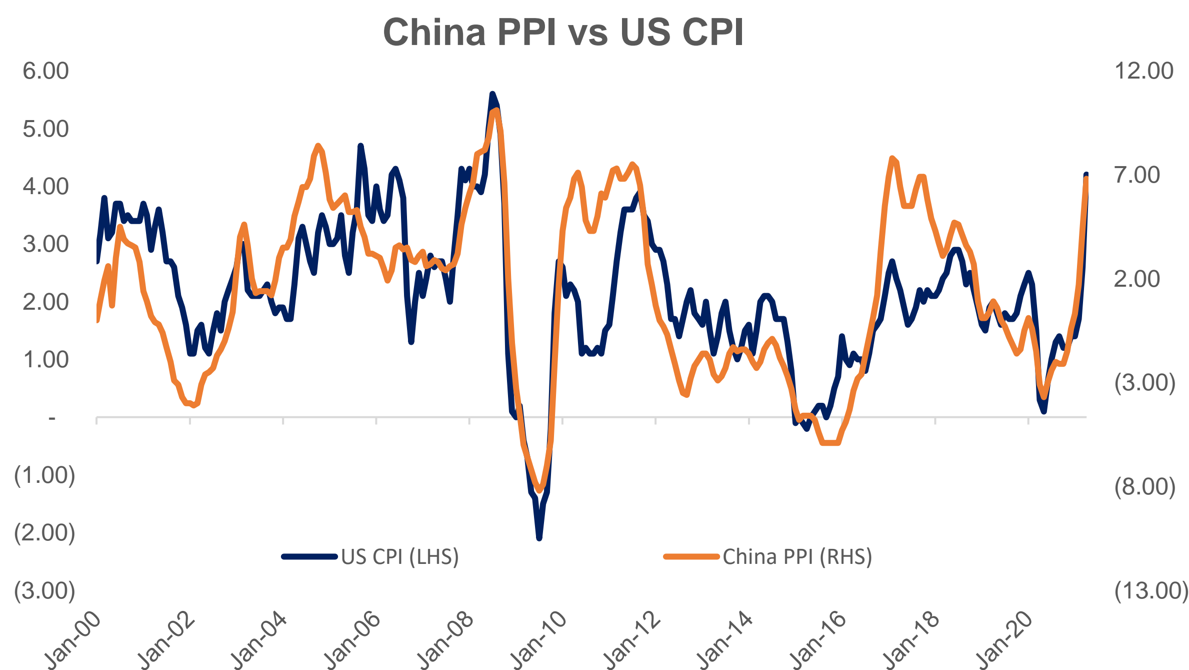


Source: Bloomberg as at 12/05/21

Cost Pressures

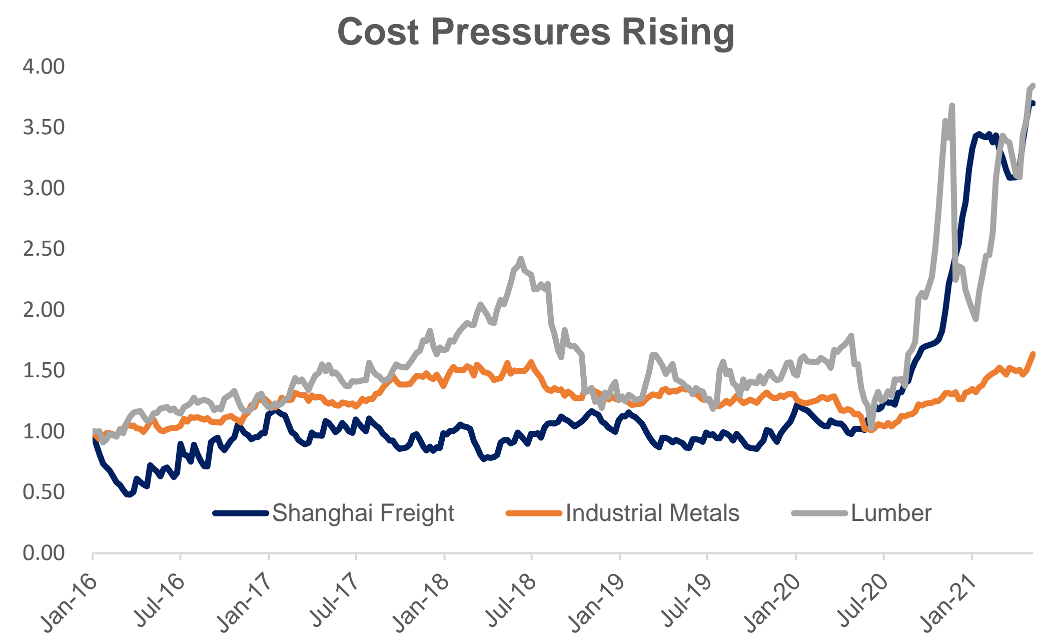
Broader global inflation levels are rising and clearly knocking on the manufacturers' doors – commodity prices and transportation levels are going to squeeze margins if higher prices cannot be passed on.

Impact of China PPI on US Inflation



Source: Bloomberg as at 13/05/21

Strong Upward Pressure on Commodities

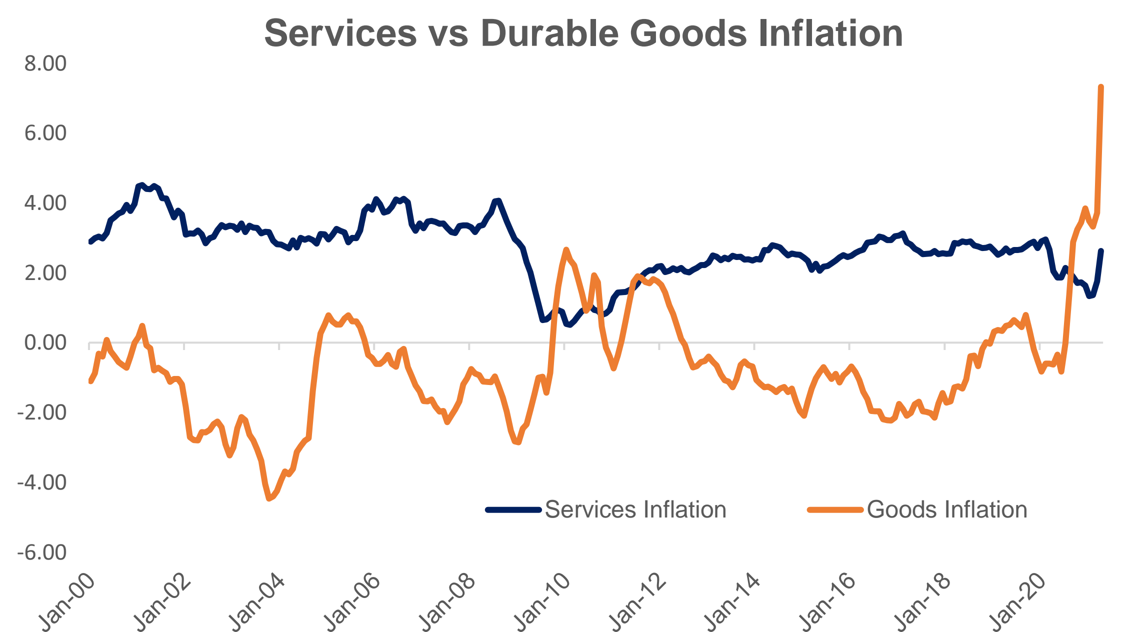


Source: Bloomberg as at 13/05/21

Is this Cycle any Different to the Last?

There are many reasons why post GFC inflation never took off in the face of extremely loose monetary policy. In short, a lack of robust fiscal support and contracting bank balance sheets had a large role to play, as did the poor transmission from monetary policy to the real economy. However, it must be noted that the expansion of the service sector led to plenty of 'on trend' inflation numbers throughout the post GFC recovery period, only to have the headline CPI figures subdued by weak goods inflation on the other side.

Goods vs Service Inflation



Source: Bloomberg as at 13/05/21

One critical aspect of the upcoming recovery, due to fiscal stimulus and supply side pressures, is that goods inflation will likely be higher in the short to medium term than was the case in the post GFC period. If we combine this with the pent up demand for services (post lockdown) and some element of lingering supply side issues, then we have some genuine inflationary impetus.

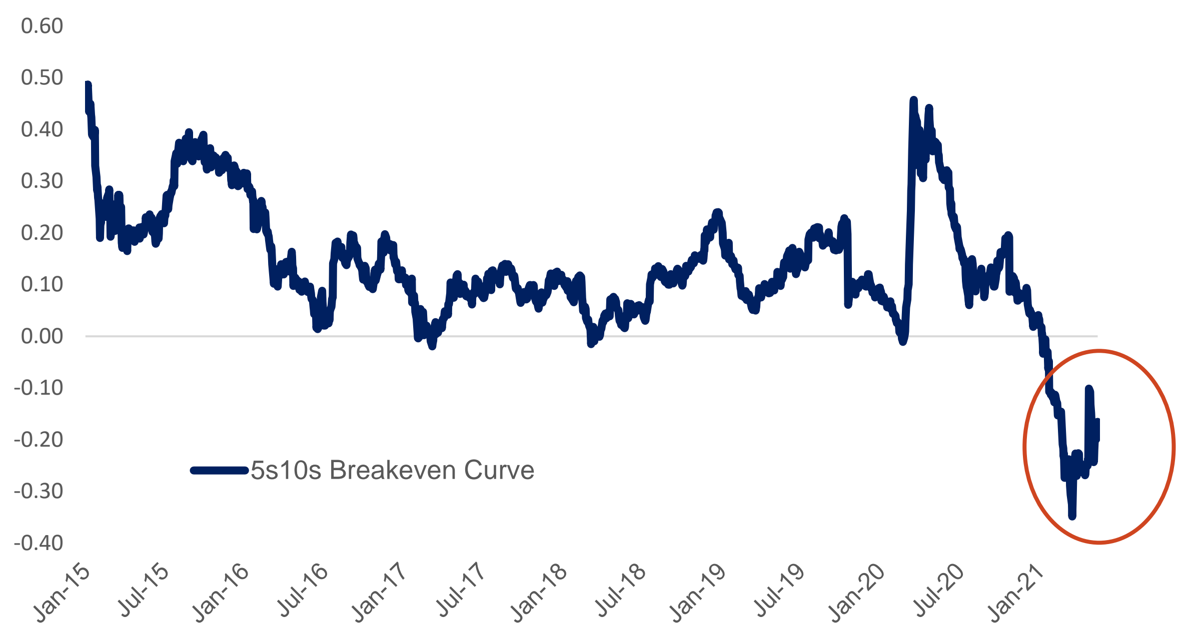
Other fundamental components of the 'official' inflation data come in the form of education, rent and health care. Education in particular has displayed a weakening trend as have rents, impacted by their own respective COVID related dynamics. As economies open up, both could potentially turn higher as more people move back into education and look for city apartments as the insatiable demand for rural lockdown living subsides

Longer Term Outlook

At present the markets still expect inflation to be transitory. This can be seen in the backwardation of inflation expectations – markets pricing a decline in inflation beyond 5 years. This dynamic will be of significant comfort to the Federal Reserve and ensures, for the moment, that markets won't fear the inflation genie is of the bottle. ***This in our view is a key indicator to watch (see top chart opposite) as it can ultimately signal the long-term directionality of rates.*** The absence of any real long term inflationary premium in the bond market corroborates this current market inflation view.

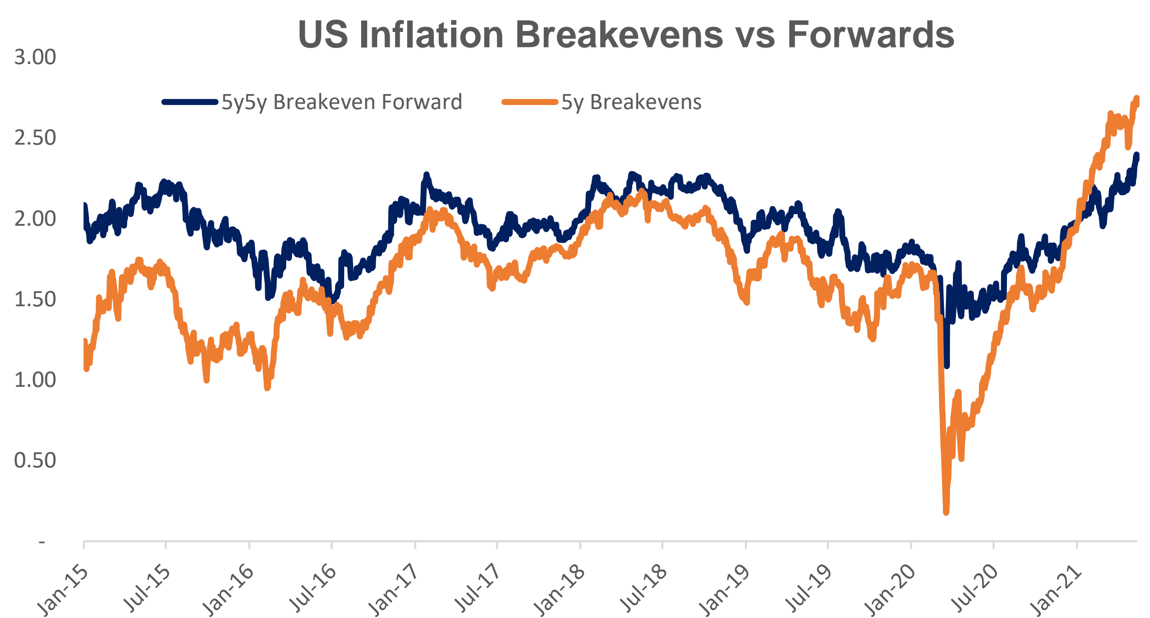
It is likely that various soft data, such as google searches and CEO comments on inflationary pressures have been boosted by a significant jump in various commodities. While these may well turn out to be transient occurrences, we should not rule out the potential for inflationary forces to permeate longer term market psychology. How long before expectations become more engrained?

Key Chart - Backwardation of Inflation Expectations



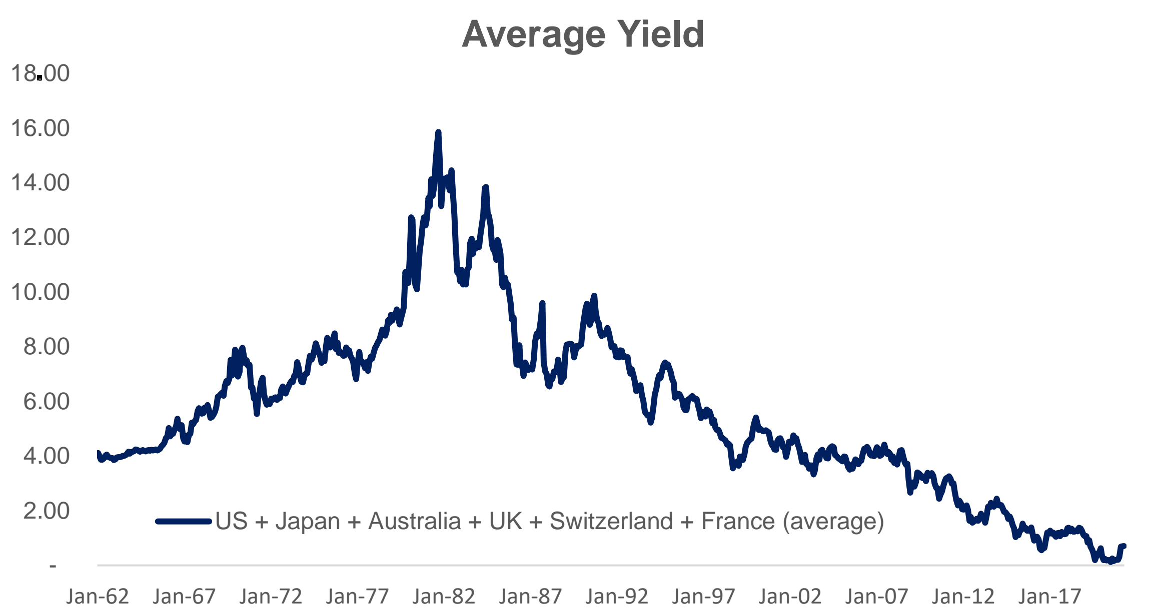
Source: Bloomberg as at 12/05/21

US 5y5y Forward vs 5 Yr Breakevens



Source: Bloomberg as at 12/05/21

Aggregate DM Bond Yields not Screaming Inflation

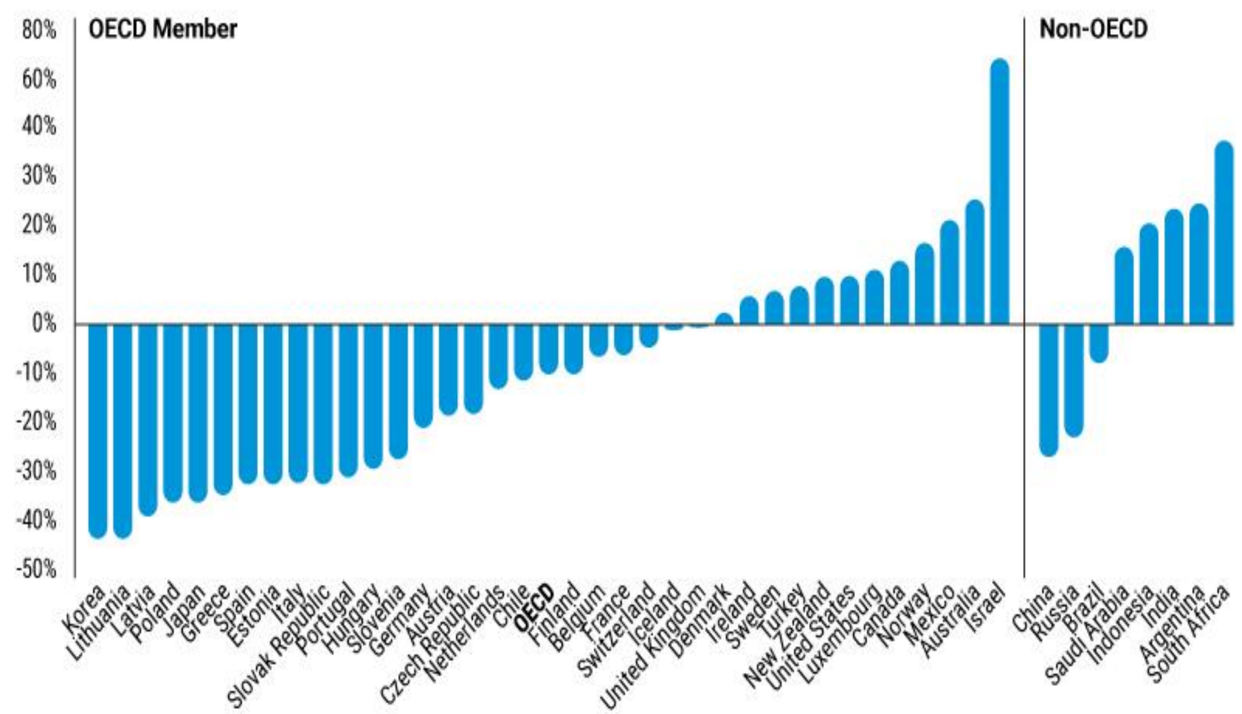


Source: Bloomberg as at 12/05/21

There are still too many factors outstanding to have a definitive answer about the longer term trajectory of inflation. In the near term, inflationary pressures are high and will continue to remain so until the autumn at least. Longer term, various structural forces will likely come into play in the form of the massive debt overhang and unfavourable demographics that can act as an anchor to higher inflation. In fact, we believe we would have to see significant currency debasement and capital outflows to be concerned about a hyper-inflationary outcome.

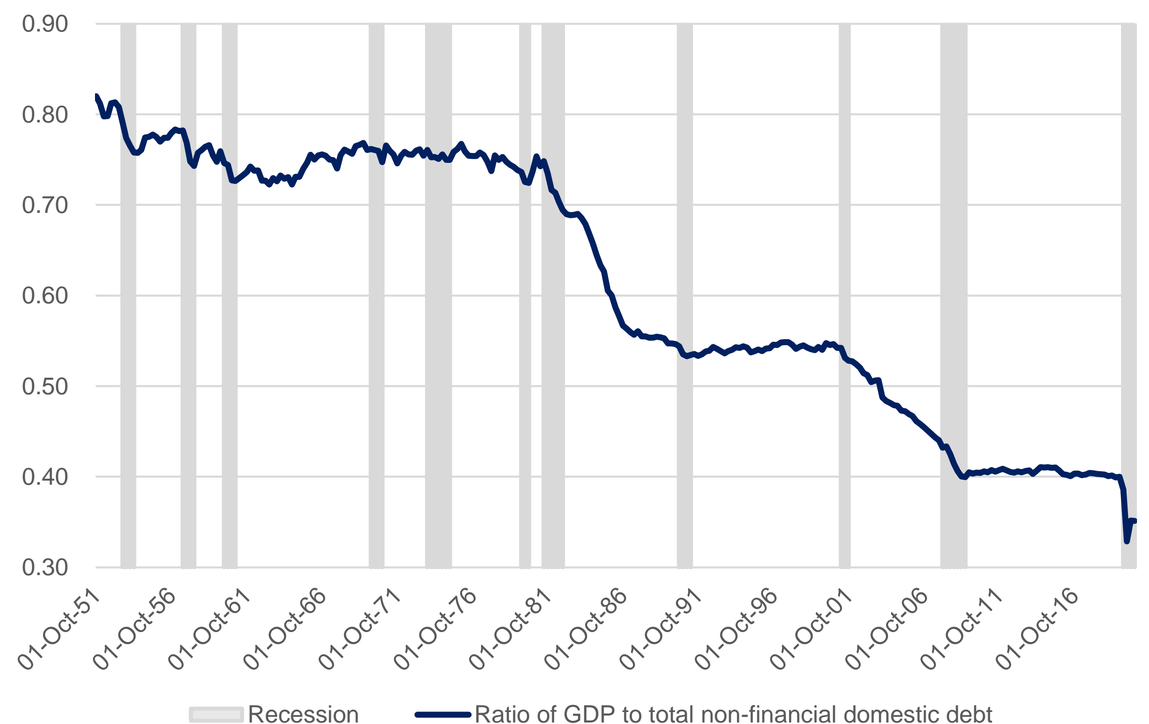
For financial markets the key question today is how overheated must the economic picture get before fiscal and monetary authorities are pressed to take their foot off the pedal. The bond market might have a say here if it feels financial conditions are too loose for too long. It is easy to suspect that Biden and Powell will go longer and further in terms of policy support. However, it might not be as easy as that. Biden is about to hit a wall in terms of Senate support for further multi-trillion dollar programmes and Powell has the slight problem of an over-inflated capital market to deal with. As far as policy makers are concerned, the easy part is done. Now comes the recovery and all of the difficult choices that will bring.

Global Demographic Challenges



Source: Visualcapitalist.com as at 15 January 2020

Debt Overhang Choking Off Growth



Source: NBER as at 31/03/2021

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