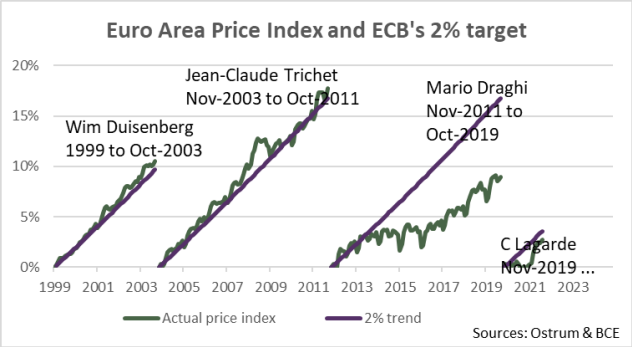
The inflation debate: where do we stand?

Key takeaways

- After a decade of persistently disappointingly sluggish inflation, the economic recovery has led to a surge in inflation rates, with certain indicators reaching 25-year highs. Part of this rally is attributable to short term effects and temporary dynamic momentum which should disappear over coming months, with the inflation graph adopting a bell-shaped profile as a result.
- The key question will be the level at which the inflation will settle, and which part will be resilient over the longer term. It is now clear that inflationary pressures are affecting many sectors, while obvious bottlenecks spreading in numerous industries will also contribute towards maintaining pressure at a high level in the forthcoming month or quarters. The key question is whether an upward inflation/wages spiral will form. For the time being, wage inflation remains at a reasonable level, although there are increasing signs of an acceleration on this front.
- Lastly, the marked shift in attitude adopted by the central banks is an important factor. They have not reacted to increasing pressure like they have done during previous cycles and therefore appear to willingly accept above-target inflation. The degree of freedom granted by the central banks is a fundamental factor in determining inflation outlook in the markets.
- In conclusion, the inflation debate has shifted. Wages inflation has essentially become the main debate. If salaries creep higher, a wage/inflation spiral will occur, with inflation probably remaining durably above the 2% targeted by the main central banks, although still far below the levels reached in the 1970s and 1980s.

Introduction

Inflation has remained at a low level for at least a decade. This has particularly been the case among OECD countries, where the inflation rate has remained resolutely below central bank targets. In the US, inflation was only 1.7% on average from 2011-2020. In the eurozone, the ECB manged to achieve its 2% objective until 2010, but inflation then fell to below-target levels throughout the following decade. The overall gap vs objectives is so wide that inflation would have to remain at 3.5% until early 2026 in order to get back on target.

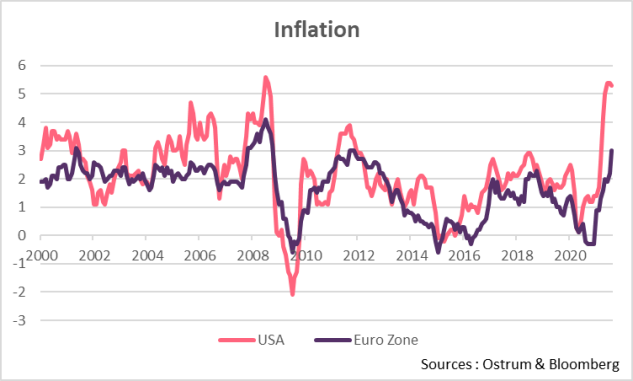


The latest set of data nonetheless contrasts starkly with the previous lacklustre trend. Prices have risen since the end of lockdown. Part of the surge has been temporary, while some of the increase is probably more durable, which is the focus of the current debate. Although it is evident that inflation should fall back next year, after the initial spike, the key question regards the level which will then be established.

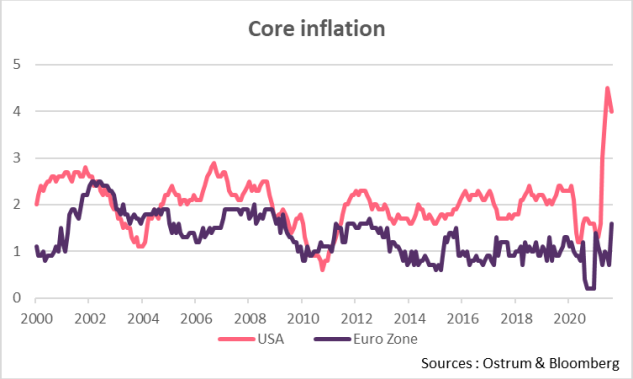
We start by presenting an overview of recent data. We then explain why things may be different this time, by analysing the forces which could maintain inflation at a higher level. Finally, we propose a range of future scenarios.

Recent inflation data

First things first, let us start with the actual inflation data. The latest figures have come in far above central bank target levels, at 5.3% in the US in August after two months at 5.4%, which is the second highest level in 30 years, while the eurozone hit 3.0% in August.



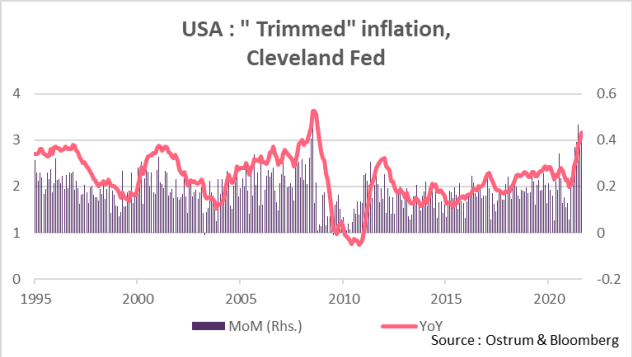
Furthermore, although headline inflation has been driven higher disproportionately by certain components, many different sectors are concerned. Core inflation (excluding the more volatile food & energy components) has risen in Europe and surged in the US to 4.5% in June, a level unseen since late 1991, followed by 4.0% in August.



The Cleveland Fed[1] trimmed index also provides a clear picture. This inflation index excludes outlying components, assuming that the biggest movers are abnormal erratic swings, and includes only the components with price changes conforming with median values. This indicator, which was launched in 1995, has surged recently, with four out of the six sharpest upticks over the last 36 years occurring during the past four months. By removing the few components

[1] Fed: the Federal Reserve System is the US central bank

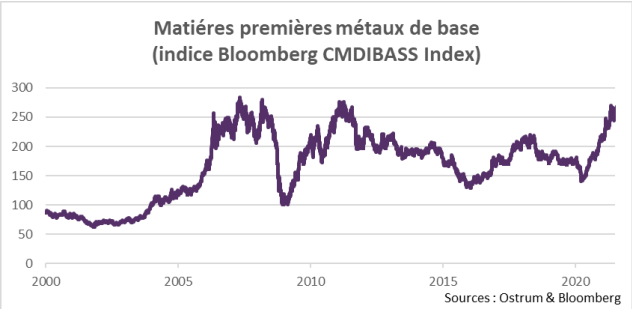
which have seen their prices spike, the index clearly illustrates the fact that inflationary pressures remain strong across the board.



Bell-shaped profile

The uptick in inflation is due partly to prices returning to normal in certain markets.

This is particularly the case for metal prices. The index has surged higher, for cyclical reasons with the economic recovery and also for structural reasons driven by demand for metals due to ecological transition. The Bloomberg index has almost doubled since the lows recorded last year (+95%) but is now stabilising.



This has also been the case among agricultural prices, which have a particularly strong impact on emerging economies. The Bloomberg index has rallied by over 50% from its lows.

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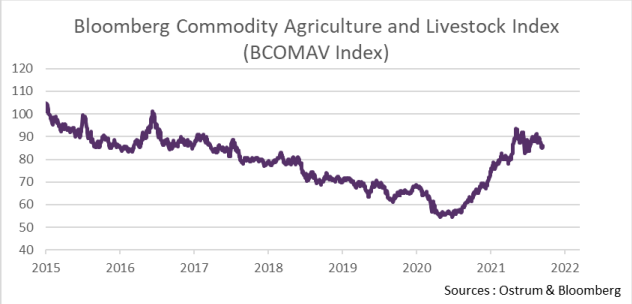
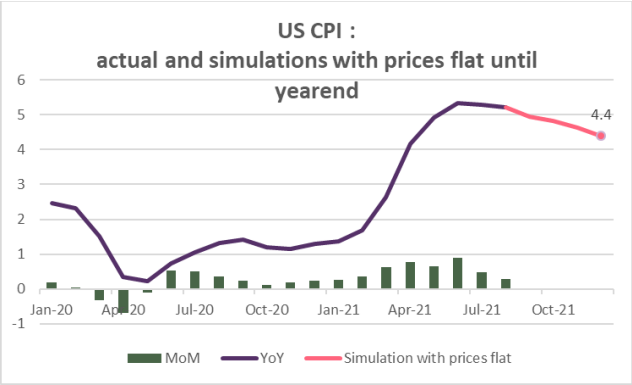


Although both price moves have contributed strongly to inflation, once prices stabilise the inflation rate will trend back towards 0%.

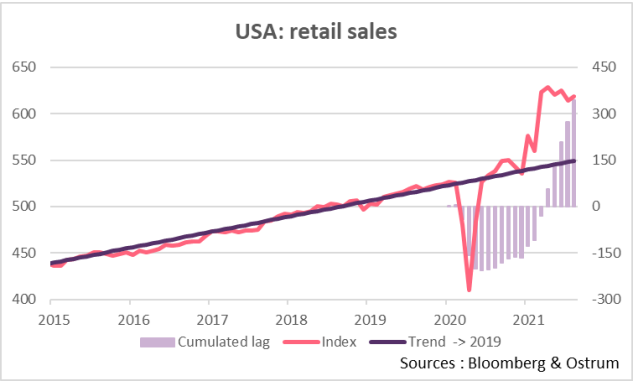
Prices will nonetheless take some time to ease. In the US for example, assuming that prices stabilise and suddenly stop rising for the rest of the year (albeit very unlikely), inflation would only fall back as far as 4.4% at year-end.



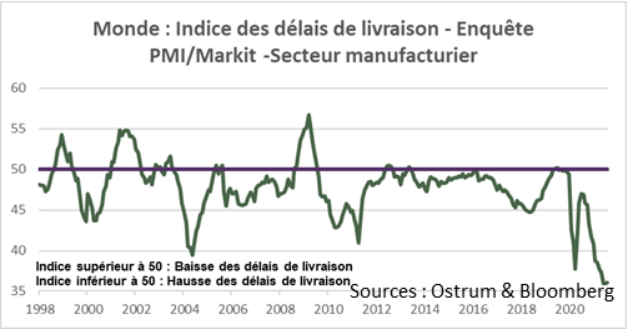
As inflation will therefore almost inevitably ease over the next few quarters, the trend should adopt a bell-shaped profile. The question then arises regarding the level at which it will fall back to. Will the inflation rate return to its pre-crisis lacklustre level, or remain on a higher trend?

Cyclical aspect

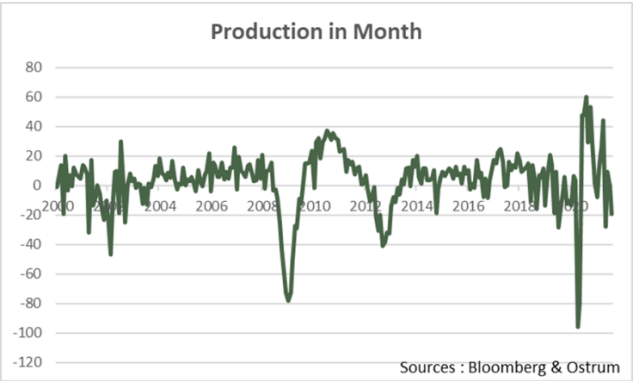
The supply/demand imbalance is one of the main reasons for price increases. In the extreme case of the US, retail sales are 15% higher than pre-Covid crisis levels, while inventories in the sector are also unprecedentedly low.



Production is therefore struggling to keep pace with demand, creating an increasing number of bottlenecks. The latest Fed Beige Book[2] report uses the term "shortage" a record 77 times.



The German automotive industry provides a glaring example, where the IFO business survey reveals that order backlogs are building up towards all-time highs, whereas expected production is in the lowest historic decile.

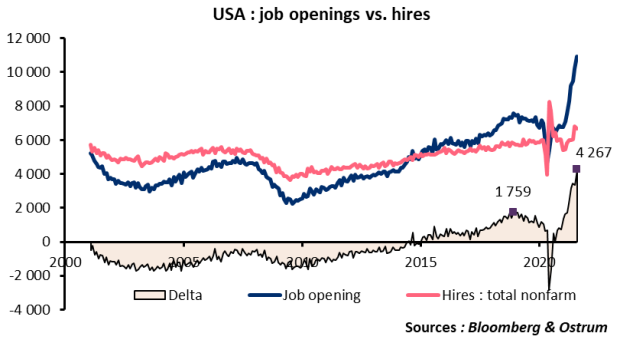


These types of production line tensions are usually correlated with future inflationary pressures. It is therefore unlikely that price pressures will disappear rapidly in many sectors.

Jobs market

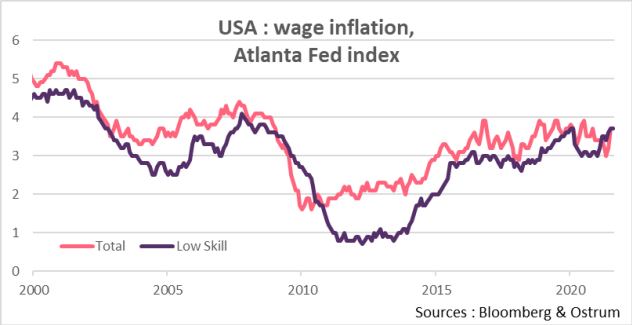
The debate over whether inflation is here to stay now appears to be focusing chiefly on the labour market. It is widely accepted that long-term inflation requires a price/wages loop to develop in order to become sustainable, which has not effectively occurred over several decades.

It should be noted however that the US jobs market is extremely strained, which would have been unimaginable just a few months ago. One of the most impressive illustrations of the tension in the market is that there are currently 11 million job openings and that this figure is 4.2 million higher than the number of hires. This situation is highly unusual.



[2] The Federal Reserve Beige Book report is published 8 times per year and includes a collection of anecdotal information regarding the economy provided by the regional Fed branches. It therefore collates microeconomic information.

For the time being, however, wage inflationary pressures are not widespread, although anecdotal evidence is fast growing. Wage inflation for lower-qualified jobs rallied particularly sharply to above the levels recorded throughout the previous cycle, and it's now at its highest level since 2008.

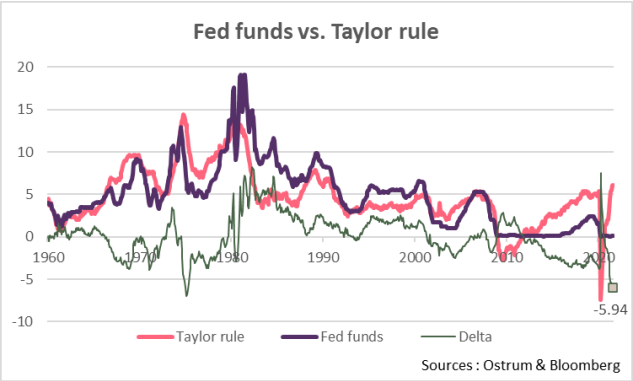


This indicator should be closely monitored, as further wage pressures would significantly increase the credibility of a long-term inflation hypothesis.

Central banks

The current stance adopted by the central banks represents a fundamental change, which has certainly been underestimated, particularly the two leading institutions, the Fed and the ECB. The central banks have driven inflation progressively lower since the nomination of Paul Volker as Fed chairman in 1979. As we highlighted in the introduction, the result over the ensuing 40 years has been that inflation has effectively been curbed but has now fallen to levels considered too low. The guidances adopted by both central banks has therefore shifted over recent months, firstly by setting higher targets and also through a more tolerant attitude towards inflation drifting temporarily higher than the stated objectives.

The following chart illustrates the consequence of this shift in attitude. Based on the standard Taylor[3] rule, Fed rates are currently almost 6% too low. The inflation tolerance threshold has effectively edged higher.

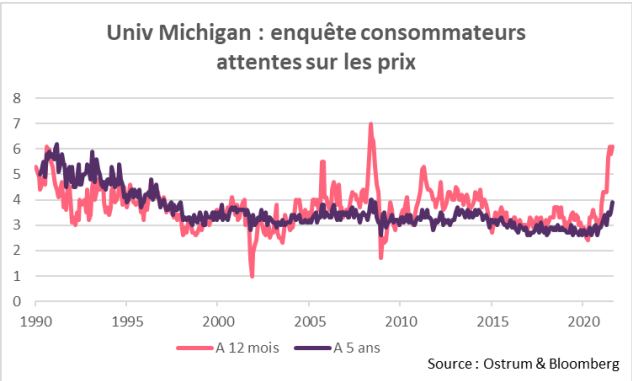


This marked change in approach must be considered in the broader context of fiscal easing however, which is another unprecedented factor. For the first time in over 50 years, growth-stimulating fiscal policies and laxist monetary policies have been put in place simultaneously, allowing for higher inflation.

Recent academic research, based on broader ranging micro-data, demonstrates the major impact of inflationary outlook on future pricing. This factor highlights the importance of central bank policy, which plays a major role in guiding expectations.

Inflation outlook in the financial markets has adjusted sharply over the past year (see below). The most spectacular change however has occurred among household expectations. The Michigan University survey has reached extremely high levels, with consumers anticipating an annual inflation rate of 6.1%. Such an excessively high expected level occurs only rarely, having previously been reached only briefly in 2008, when the oil price approached 150 dollars per barrel. Inflation outlook has never remained this high before in over 30 years, excluding during oil crises. The Fed's lack of reaction and persistently laxist attitude will certainly not invert this trend in the near term.

[3] The Taylor rule takes growth and inflation into account to determine the optimal level for central bank base rates.

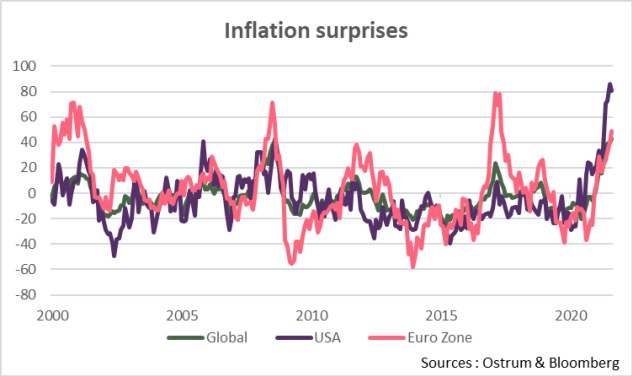


Although it is difficult to accurately assess the impact of current monetary policies, particularly as the shift in approach has occurred only recently, the significant U-turn operated should not be underestimated.

A marked shift in outlook

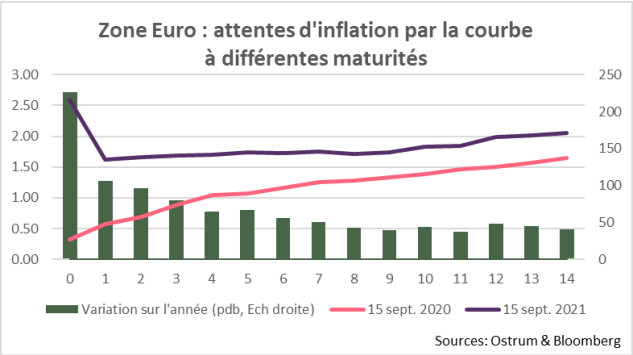
In parallel with the shift in policy adopted by the central banks, there has also been a marked change in inflation outlook. Empirical studies demonstrate that outlook is a key factor in determining future prices, particularly wage negotiations which are influenced by expectations.

The first point to highlight is that forecasters were completely wrong-footed by the recent surge in prices. The Citibank surprise inflation index has reached an unprecedented peak in the US and risen to high levels across the board.



Similarly, inflation outlook indicators in the markets have also spiked. In September of last year, the US curve was predicting that inflation would take almost a decade to climb back up to 2%. A year later however, the same indicator is now not only reflecting the fact that inflation has already exceeded 2%, but it is also predicting that the rate will never fall back below this level. This marks a significant shift in scenario.

The trend is also similar in Europe, where one year ago the outlook curve was indicating that inflation would not reach 2%, even within 30 years. The same indicator is currently predicting a bell-shaped inflation curve above 2%, which will ease slightly but dip back below 2% only after 10 years.



Although changes in short-term outlook have been strongly influenced by recent surprises in the inflation rate, the resurgence of higher long-term expectations show that the market view is changing with regard to the durability of inflation.

This is another illustration of the current shift in inflationary outlook. The change in policy adopted by the central banks has probably had an impact on the current swing in outlook and will also determine future dynamics.

Conclusion

Several conclusions can be drawn from the available data.

On the one hand, the main topic of the debate has changed considerably over the past year. Previous concerns over deflationary risks due to a recession have been replaced by a debate on limited inflationary risks, due to a surge in the oil price, then followed by more widespread price increases. Although the facts are now generally accepted, the key question is at what level inflation will stabilise over the medium term following the post-crisis surge. The

wages/inflation spiral is crucial to this debate. Wages are increasing in some sectors and if this pressure becomes more generalised, which is plausible, inflation will be much more resilient than anticipated.

Where are we heading in terms of level? We are still very far from the 1970s and 1980s. Developed economies are unlikely to see an inflationary scenario with rates durably well above 5%. If an inflationary regime develops, the rate is likely to remain above the ECB and Fed 2% targets. This would therefore mean an inflation scenario in a range of 2 - 5%, which is significantly higher than over the past two decades, but nonetheless remains reasonable.

Although this range is far from outrageous, such a scenario may trigger a number of major adjustments in the markets.

- Firstly, an inflation rate of 3 - 4% over several years would significantly distort corporate margins between sectors. It should not be overlooked that different sectors do not experience inflationary periods in the same way and that certain businesses, which are unable to pass-on price hikes to their clients, are heavily penalised over the longer term.

- Secondly, persistently low interest rates would weigh even more on savers. The so-called “financial repression”, which enables the gradual absorption of the debt burden, would be all the more painful for savers if inflation were higher.

Inflation will profoundly disrupt the balance between certain financial equilibriums before it reaches the levels experienced in the 1970s. Even an increase in inflation to apparently reasonable levels will have a major impact.

Stéphane Déo - Head of Market Strategy

Written on 15 September 2021.

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Additional notes

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