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The growing inflation puzzle

You could be underestimating inflation risks. Here's a summary of what we think's really happening in the global economy

The upswing is possibly being underestimated

The financial markets have started 2018 where they left off in 2017. Manifold geopolitical risks continue to be treated as background noise, and a stream of mildly positive growth surprises continue to keep asset prices buoyant.

In our view, forecasters may still be underestimating the upswing

If the ramifications of the upswing are being downplayed, a bigger threat to the markets' mood may come from inflation. 2018 may give some answers to the puzzle as to why inflation hasn't already stirred. The US growth story is going from strength to strength. The domestic economy is firing on all cylinders and the external picture continues to brighten. This is creating a sense that a pick-up in inflation may not be far away.

Core inflation rates remain low for now, but, with a tight jobs market risking higher wages and the strength of the housing market set to feed through into a stronger contribution from shelter, we doubt this will last. Moreover, with oil prices rising and business surveys suggesting price pressures are building, we see upside risks to our forecast for three 25bp Fed interest rate rises this year.

Be wary of big sentiment swings

Politics remains a risk with President Trump sounding increasingly bellicose in his approach to North Korea, Iran and Pakistan. For now, markets are brushing this aside. Instead, they are focusing on the windfall from tax reform that will likely lead to share buybacks and more M&A activity.

> *Sentiment could change quickly should talk turn into action*

The Eurozone recovery seems to be going into overdrive, with the latest indicators suggesting a 3% annualized growth pace around the turn of the year. While we doubt that this pace will be maintained throughout the year, we believe that GDP growth in 2018 will be at least as good as in 2017. While inflation pressures are now becoming more visible, the ECB is unlikely to end its quantitative easing (QE) bond purchasing programme prematurely.

Inflation, or more precisely wage growth, will be key to whether the Bank of England will hike interest rates this year. There have been some better signs of late, but we're still not fully convinced pay will pick up quite as fast as policymakers hope. That, and the fact UK growth is set to stay sluggish this year, means a rate rise is not yet guaranteed.

China is preparing to smooth out liquidity tensions around the Chinese New Year. We suspect the usual high money market rates won't be repeated. We also see that the regulator is closing loopholes regarding capital outflows.These measures highlight how careful the central bank is being in the year of financial reform.

The possibility of a rate rise in Japan is also increasing. However, we suspect the Bank of Japan (BOJ) will wish to see not just current real growth rates maintained, but some uplift in inflation before it moves starts to move on its Quantitative and Qualitative Monetary Easing (QQE) with Yield Curve Control.

Despite all the positive noise coming out of the US, the dollar is not rallying. In our opinion, this is because there are better re-rating stories in overseas economies – especially in Europe. We maintain an end 2018 EUR/USD forecast of 1.30. The upside break-out should come in 2Q18 when Italian political risk has passed and the market is once again debating the end of the ECB's QE programme.

This article comes from our Monthly Economic Update. Download the full report here.

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