

The return of inflation

The return of inflation could be a major theme in markets this year. It will force the Federal Reserve and the European Central Bank to balance even more carefully its communication to avoid any taper tantrum



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It's not quite the return of the Living Dead but the comeback of an almost forgotten relic from the past could haunt financial markets this year: inflation. In both the US and the eurozone, headline inflation is set to reach levels last seen years ago. In the US, we see headline inflation above 3% in the second and third quarters, with core inflation likely to breach 2.5%. In the eurozone, headline inflation could reach the 2% mark in the second half of the year. At first glance, these developments are linked to higher energy prices, some catch-up of price increases after the end of lockdown restrictions, and in the case of the eurozone, the reversal of the German VAT cut. The key question for markets is how sustainable all of this will be.

Inflation prospects in the US and the eurozone

In the US, inflation in the near term will be pushed higher by base effects as a weak 2Q/3Q last year is compared to (hopefully) a vibrant 2Q/3Q 2021. Remember that at the nadir of March-May 2020, businesses were shut and travel came to a standstill as people were told to stay at home.

Companies were desperate for cash to pay staff and creditors and were willing to sell at deep discounts.

In contrast, we are all hoping that 2Q 2021 will be a period of economic re-awakening, with the vaccination programme having gained momentum and Covid hospitalisations plunging, thereby allowing Covid containment measures and economic restrictions to be lifted. With households and businesses free to spend, supported by high savings levels, low credit card balances and additional government cheques, we are likely to see vigorous pent-up demand.

We are hearing some monetarists suggest that the risks are skewed towards even higher numbers than our 3-3.5% forecast. These analysts are concerned that broad money supply is accelerating across this world and with the velocity of money set to pick up on an economic reopening, more vigorous inflation is inevitable. Separately, there is also concern that higher energy prices and a weaker dollar could add to US headline inflation.

At the same time, there is justifiable concern that supply capacity has been destroyed in some areas of the economy. Airlines have laid off staff and mothballed aircraft, many hotels, bars, restaurants and gyms have gone out of business, while numerous retailers have shuttered stores. Consequently, vigorous demand coming up against supply constraints will allow for price levels to recover to pre-pandemic levels and possibly beyond very quickly. This could make the year-on-year inflation rates look alarming for a time.

The situation in the eurozone is not so different. In fact, the reopening of the economy could bring similar upward pressure on prices, at least in some sectors. However, the current problems with new infections and vaccinations imply that the reopening of the economy will come later than in the US. Also, the stronger euro will dampen the upward pressure from higher oil prices, at least when compared to the US. The reversal of the German VAT reduction, as well as a CO2 fee, will insert additional upward pressure on headline inflation in the second half of the year.

It's all about the second round

All of that said, most of the drivers of inflation in 2021 will have faded by 2022. They will peter out of the headline inflation numbers because they're mainly base effects. More important is inflation in the service sector. In the US, developments in non-energy services, which make up 60% of the inflation basket, will dominate. Actual rents in major cities are falling and owner equivalent rent is depressed for now. The contribution from these components will eventually creep upwards on higher house price inflation, but booming housing construction should bring supply and demand into better balance this year. In the near-term, it is wages that drive inflation in the service sector. We have barely had any wage inflation over the past decade and with 10 million fewer people in work than 12 months ago, there is little reason for that to change soon. In the eurozone, the situation is very similar. Ongoing structural change in many economies, as well as the fact the eurozone economy will not return to its pre-crisis level before 2023, offers little room for wage increases. Digitalisation and demographic change will also continue to exert downward pressure on inflation in the longer run.

So, while a period of above-target inflation looks probable, there are structural forces at play that will limit the threat of it becoming entrenched over the medium to longer-term.

What to expect from the Fed and the ECB?

The latest changes to the Fed's monetary policy strategy show that the central bank has clearly allowed for inflation to overshoot. Developments in 2021 will be the first test case for the Fed's determination to actually implement this strategy. Given that we expect the ECB to follow in the Fed's footsteps with its own strategy review, introducing more symmetry to its inflation target and hence also allowing for an overshoot, looking through 2021 developments seems to be the most likely option. Still, never underestimate the power of financial markets. If the surge in headline inflation were to coincide with a massive reduction of savings and consequently an enormous boost in economic activity, some market participants and also central bankers could start to get nervous. Diverging statements from individual central bankers could easily trigger upward pressure on inflation expectations. Both the Fed and the ECB will want to avoid a taper tantrum this year. Therefore, we expect them to use forward guidance first to anchor inflation and rate expectations. If need be, a bit of 'operation twist' or yield curve control could be the next preferred option, capping any upward pressure on longer-term yields.

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