INFLATION: DON'T LOOK UP

March 2022

The evidence was there for everyone to see. And yet the authorities chose to ignore the threat, dismissing it as "transitory", their dots and gazes firmly fixed no higher than the horizon and the promise of smooth sailing as enjoyed up until now. But reality sank in and the markets tanked, when the central banks finally decided to counter inflation with aggressive rate hikes over the next year. Now it's official, US consumer prices surged by 7.9% on a year-on-year basis in February, with no apparent end in sight. To make matters worse, the Ukraine crisis propelled many commodity markets to record highs. Although fears of an inflationary spiral may now seem justified, a deeper analysis suggests otherwise. We believe, in fact, that the peak of inflation is very near.

While inflation represents the balance between supply and demand for goods and services, its scale and length depends on its triggers and their drivers. An inflation shock reflects an unbalanced situation, which can come from either higher than expected demand, lower supply because of disruption, or both. It's also usually a backward-looking indicator, reflecting past imbalances that tend to revert to the mean, as changes in price dynamically recalibrate supply and demand and reduce the asymmetry between the two over time.

In this short paper we will explain how the current high level of inflation is the result of an exceptional situation, driven by an uneven policy mix and a "no inventory/just in time" supply chain. Our "inflation peak" view is based on the following factors:

1. Reversing supportive policy mix
2. Easing in bottlenecks
3. Limited risk of an inflationary wage spiral
4. Large base effects ahead, even with a higher geopolitical risk

How Far "Behind the Curve" Is the Fed?

With price stability being one of the pillars of its dual mandate, the Fed has always reacted to rising inflation surprises. Over the last five decades, the only time the Fed did not change its stance despite an upward inflation surprise was between 2010-2011, when US activity and inflation were both recovering from very depressed levels and Europe was struggling with its own financial crisis. Nevertheless, that surprise was small compared to the current one. Figure 1 illustrates how late the Fed has been so far to react to the most recent inflation shock.

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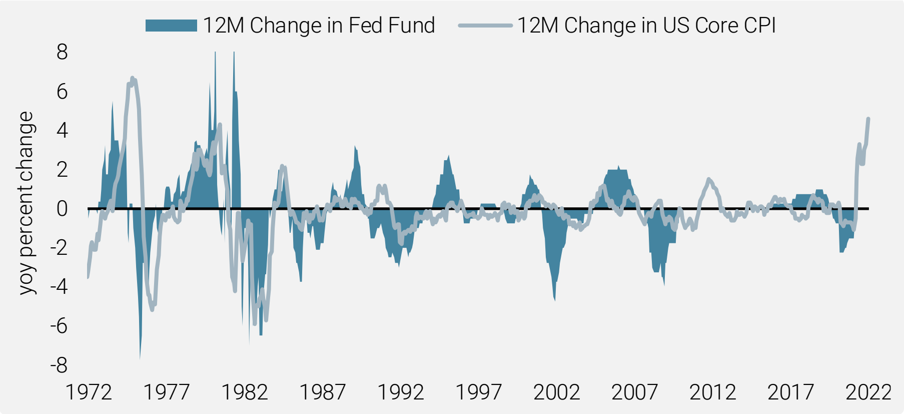
Key Points

1. The current inflation surge is the result of an exceptional confluence of Covid-related events
2. Despite increased geopolitical risk, inflation looks set to cool significantly in 2022
3. From its current 7.9% peak, we expect US CPI to drop towards 3% in December

Figure 1: 12m Change in Fed Funds vs Core Inflation

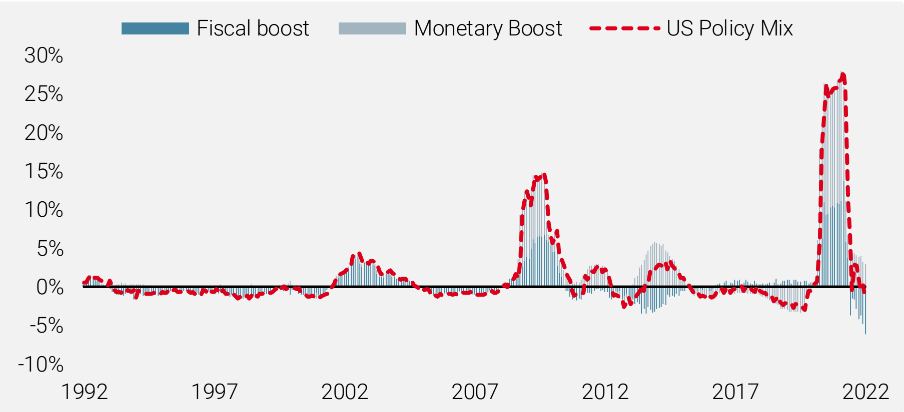


Sources: Unigestion, Fed, BLS.

How Exceptional Is the Current Inflation Spike?

Monetary authorities could argue that the current situation is exceptional, because the Covid crisis and the lockdowns thrust the global economy into unchartered territory. This is true in terms of the massive policy support that ensued. Never before did central banks' balance sheets balloon by so much (Figure 2). Monetary stimulus and fiscal measures combined boosted demand by a massive 25% of US GDP in 2021; roughly double the 2008 policy-mix support and eight times the one provided in 2001.

Figure 2: US Policy Mix in GDP Terms

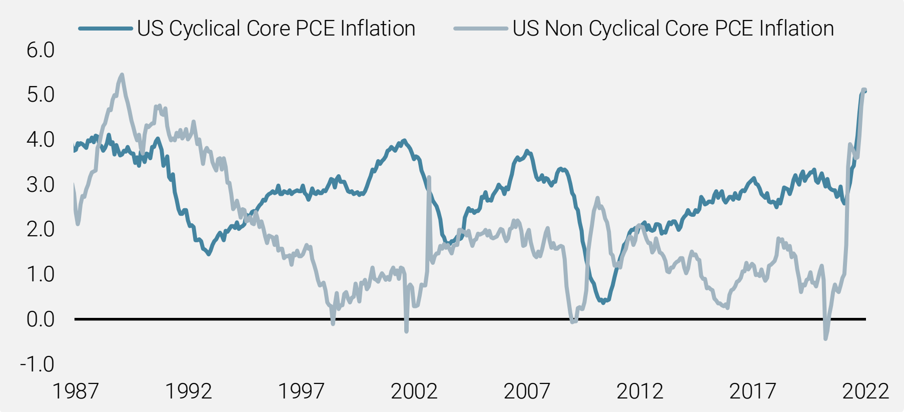


Fiscal boost represented by the 12m change in US fiscal surplus/deficit as a % of GDP.
Monetary policy boost represented by the 12m change in Fed balance sheet as a % of GDP,
Sources: Unigestion, Fed, BLS. Data as at 28.02.2022

This aggressive policy mix, implemented by the US administration and the Fed, caused both cyclical and non-cyclical inflation components[i] to surge at the same time, which has never occured since 1985. Previous jumps in non-cyclical components were associated with declining cyclical components as in 1987, 2022 and 2009 (Figure 3). The current situation therefore looks exceptional, featuring a positive correlation between both components, as well as a record jump for the non-cyclical elements. It reflects the magnitude of inflationary pressures piling in from both sides: higher demand and disrupted supply.

"The current situation reflects the magnitude of inflationary pressures piling in from both sides: higher demand and disrupted supply."

Figure 3: US Cyclical and Non-Cyclical Core Inflation (YoY, %)



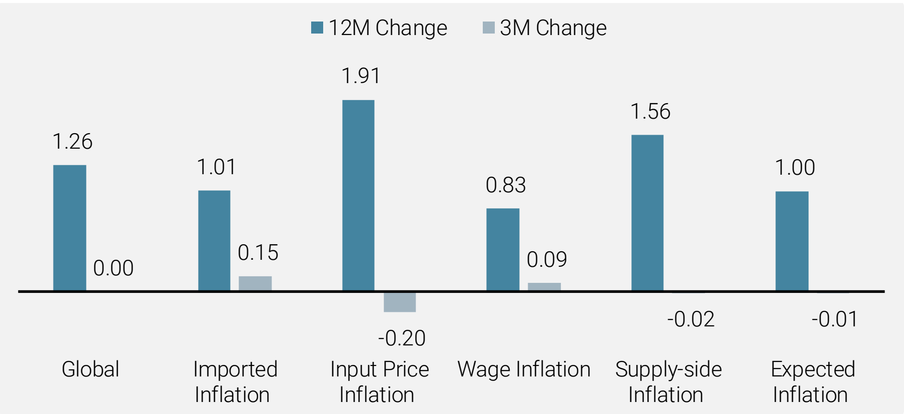
Sources: Unigestion, Fed, BLS. Data as at 28.02.2022

How Long Can the Current Trend Last?

We monitor the risk of an inflation shock through our proprietary Nowcasters, which track supply and demand pressures for a large spectrum of sectors and countries in real time. The bad news is that the US Inflation Nowcaster currently stands at a very high level. Nevertheless, the good news is that this dynamic is reversing. As shown in Figure 4, the 3-month change for sub components of our US Inflation Nowcaster are null or slightly up. Moreover, the Atlanta Fed inflation report shows a decline in 3-month annualised prices for both Core Flexible and Flexible readings, confirming our view that inflation has peaked.

"The bad news is that the US Inflation Nowcaster currently stands at a very high level. The good news is that this dynamic is reversing."

Figure 4: US Inflation Nowcaster by Components



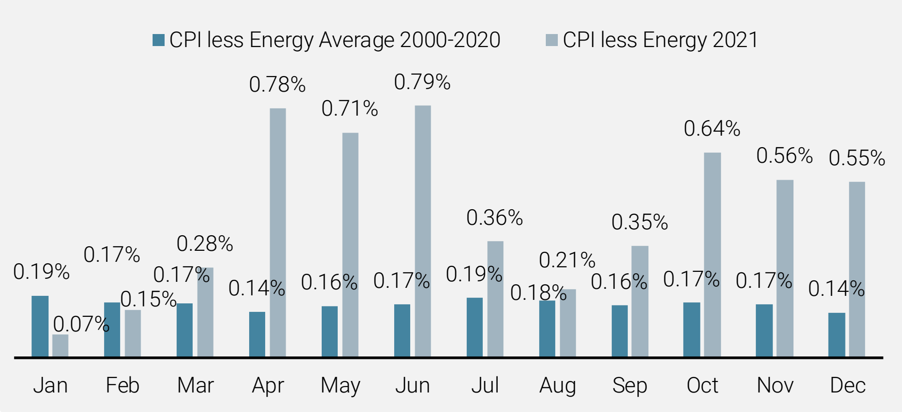
Sources: Unigestion

In our view, core inflation should decelerate thanks to three key elements:

1. Base effects

Indeed, the base effect for the US CPI less energy will be large in the coming months. As depicted in Figure 5, which compares the monthly change observed last year versus the average over the last 20 years, the biggest surprise in realised inflation occurred in April, May, and June 2021.

Figure 5: Monthly Change in US CPI Less Energy

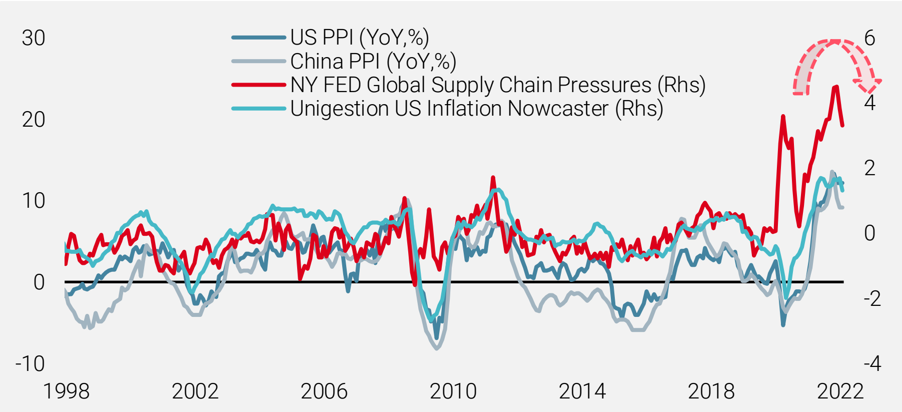


Sources: Unigestion, BLS, Bloomberg. Data as at 28.02.2022

2. Easing in some bottlenecks and inventory rebuilding

The dynamic in producer prices is also encouraging, as they are decelerating in China. As shown in Figure 6, correlation with US producer prices is historically very high and suggests a similar reversal in the coming months for the US, which in turn should give some flexibility for corporate pricing. Moreover, as highlighted by the NY Fed indicators that track Global Supply Chain Pressures, bottlenecks are easing in 2022 with most of its sub-components decreasing in January and February, which is in line with our US Inflation Nowcaster, indicating a peak for US inflation.

Figure 6: Supply Chain Pressures and Producer Prices (YoY, %)



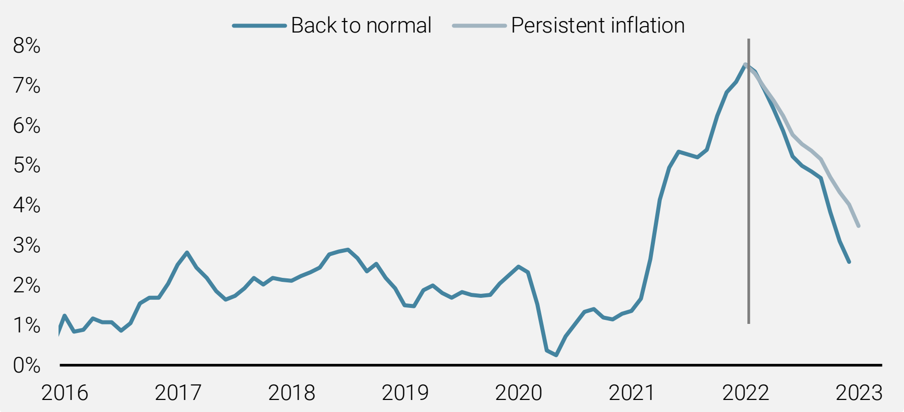
Sources: Unigestion, Fed, BLS. Data as at 28.02.2022

3. Lower demand as fiscal boost ends and change in monetary policy expectations signals the end of easy money

As a result, our analysis of the drivers of the surge in US inflation leads us to forecast a large deceleration that could happen soon. A "back to normal" scenario, assuming that monthly changes in 2022 align with the ones observed between 2000 and 2020, would lead to a peak in headline inflation in February 2022 at 7.9%, declining to 5.5% in June and ending the year around 3.0%. A scenario of "persistent inflation", corresponding to injecting half of the monthly changes observed in 2021, already much higher than the historical ones, would result in US headline inflation at 6.3% in June and at 4.5% for end of this year (Figure 7). In both cases, the deceleration will be large and ease the pressure on central bankers to normalise "Volcker" style.

"A 'back to normal' scenario would lead to a peak in headline inflation in February 2022 at 7.9%, declining to 5.5% in June and ending the year around 3%."

Figure 7: US Inflation Under Two Scenarios



Sources: Unigestion, Fed, BLS. Data as at 28.02.2022

How Big Is the Risk of a Policy Mistake?

In our view, the major and only risk for the US economy and the path of Fed normalisation would be a continued rise in wage growth that would push inflation pressures higher and corporate profitability lower. To assess its magnitude, we employ various relationships connecting inflation, unemployment rates and wage growth. Historically, Okun's law implies that stronger activity leads to lower unemployment rates and higher inflation, while according to the Phillips curve, the lower the unemployment rate, the larger the wage growth. Plotting these three variables shows that current relationships don't support the inflation/wages spiral narrative.

Firstly, the current Phillips curve appears flatter than the historical one, reflecting a lower wage growth sensitivity to changes in employment. Figure 8a also shows that current wage growth at 5.8% is in line with past episodes of low unemployment rates. Secondly, as shown in Figure 8b, given the current level of inflation, wage growth would be much higher historically. In our view, wage growth would need to be above 7% on a YoY basis to justify the likelihood of an inflation/wage spiral scenario. Given the decline in medium-term inflation expectations from households exhibited in the latest NY Fed survey, we doubt that wage growth will reach this level.

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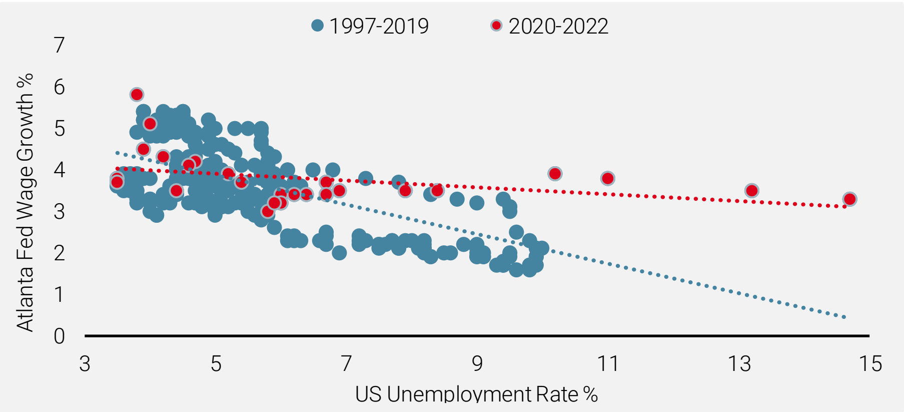
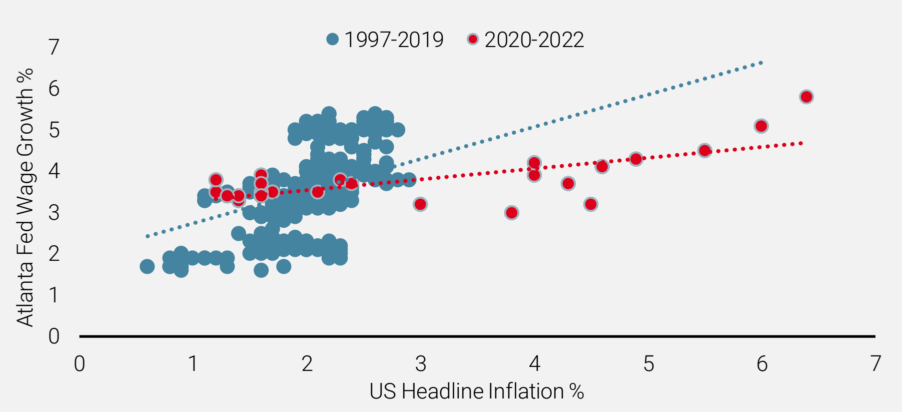
Figure 8a: Historical Wage Growth and Unemployment Relationships vs Current



Sources: Unigestion, Fed, BLS. Data as at 28.02.2022

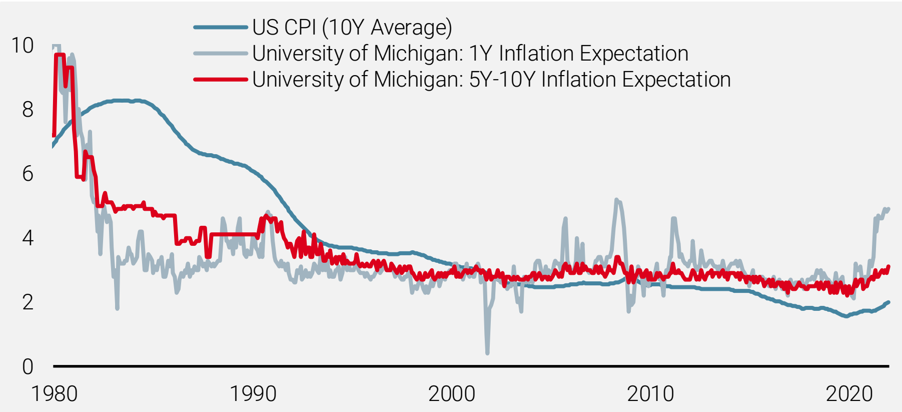
Figure 8b: Historical Wage Growth and Inflation Relationships vs Current



Sources: Unigestion, Fed, BLS. Data as at 28.02.2022

Moreover, recent studies from both the Federal Reserve Board and the NY Fed[ii], show that realised inflation doesn't drive long term household inflation expectations. The main argument of these studies is that households strongly believe that any short term change will reverse on a longer term horizon. This conviction anchors their long term inflation expectations around the central bank target and doesn't determine the wage rate that they are willing to accept (Figure 9). This stability in expectations upholds the credibility of the Fed's monetary policy. It also applies to most other economies, as documented by the recent the BIS study[iii], outlining the stability of medium term inflation expectations, despite the strong rise in realised inflation.

Figure 9: Short vs Long Term Household Inflation Expectations



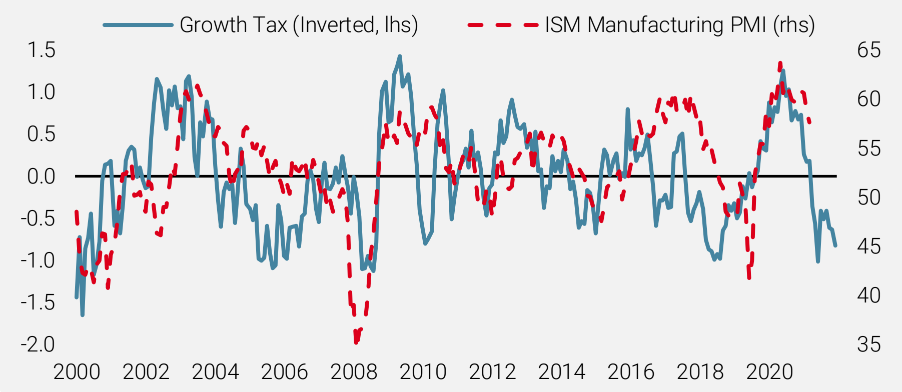
Sources: Unigestion, Fed, BLS. Data as at 28.02.2022

In our view, the risk is, on the contrary, that household demand decelerates too much. We continue to see depressed consumer sentiment, high prices, and negative real wage growth threatening consumption in the first half of this year.

Overall, the Fed has stepped into the inflation-fighting arena exceptionally late. Forward-looking indicators such as orders books, inventory/sales ratios, or the forward short-term yield curve indicate that beneath the surface, the robustness of the US economy could be questioned sooner than expected. Adding to this fragile situation, tighter financial conditions could create a marked slowdown via the inventory cycle. A vicious negative feedback loop, starting from depressed consumer confidence, translating into lower demand and slowing orders, would lead to excess inventories and subsequently to a classic recession, triggered by a monetary policy mistake. Looking at Figure 10, the picture could quickly deteriorate if the "Growth Tax" continues to worsen.

> "In our view, the risk is, on the contrary, that household demand decelerates too much."

Figure 10: US Policy-Mix: From Boost to Brake



Growth Tax is a combination of the US dollar, oil prices and interest rates, advanced by 9 months. It expresses their negative impact on the US economy, working as a growth tax.
Source: Bloomberg, Unigestion. Data as at 28.02.2022

The recent surge in inflation is the result of an exceptional confluence of events since Covid first hit the planet: US fiscal boost equivalent to 25% of GDP, ultra-loose monetary policy, pent up demand, and severe supply bottlenecks across the globe all combined to create the perfect inflationary "storm". This dynamic is now going into reverse, and given the moderate risk of a wage spiral and very strong upcoming base effects, the stage is set for inflation to peak in the not too distant future, if it hasn't already done so. Although geopolitics may influence the timing of the peak by temporarily increasing inflation pressures, markets should rather focus on the growth outlook and the pace of its deceleration, as inflation risk is already priced into the bond and commodities markets. Indeed, inflation tells a tale of the past, and from the evidence we see going forward, it should cool down significantly in 2022.

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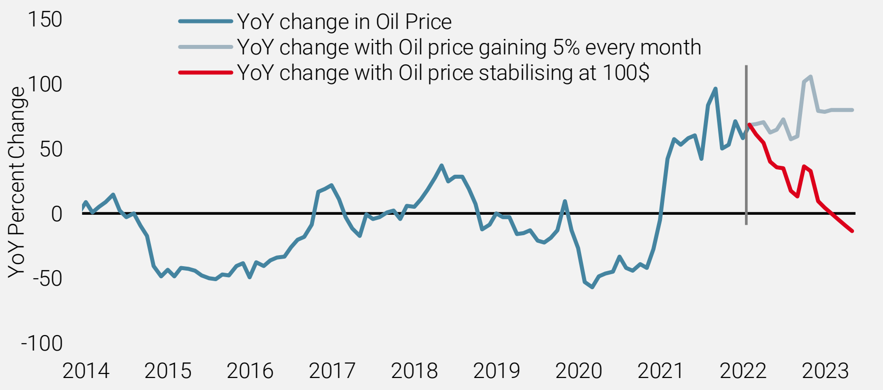
The Oil Base Case

To illustrate the significance of the upcoming base effects, let's focus on the market which has been making all the headlines lately. WTI oil recently broke through the $100 barrier, nearly doubling in the space of one year. So WTI oil would need to grow at the same pace over the next year, just to stay at the same year-on-year "inflation" rate. Assuming an oil price currently at $100 that increases by 5% every month for the next 12 months, it would be at $180 in a year, but its yoy inflation rate would remain nearly constant. Hence, even if oil were to rally to these high levels in a year's time due to ongoing geopolitical tensions, it would hardly make a dent in the US headline CPI next year because of its large base effect. Moreover, in Europe, where the situation could turn dramatic due its energy dependency, most of the countries heavily tax gasoline, giving them more leeway to absorb crude price increases and thereby limit the pass-through effect to consumer price inflation.

Figure 11: 12-Month Scenarios for WTI Oil Inflation



Sources: Unigestion Bloomberg. Data as at 28.02.2022

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[i] To determine which core PCE categories are more cyclical or acyclical, the Mahedy-Shapiro method estimates a Phillips curve model that relates the changes in prices for a category to the unemployment gap. If the relationship between the unemployment gap and the category's inflation rate is negative and statistically significant, the category is considered cyclical. If not, it is considered acyclical. https://www.frbsf.org/economic-research/indicators-data/cyclical-and-acyclical-core-pce-inflation/

[ii] https://www.federalreserve.gov/econres/feds/why-do-we-think-that-inflation-expectations-matter-for-Inflation-and-should-we.htm
https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr1007.pdf

[iii] https://www.bis.org/publ/bisbull51.htm