Sanctum Wealth Management

THE BIG PICTURE OF GLOBAL ECONOMICS

GLOBAL CIO WEEKLY **BY GARY DUGAN**

July 19, 2021

The Fed's Transitory Indifference?

- **US Inflation surprises (again) to the upside**
- **More signs of less-than-transitory inflation**
- **Blackrock shows there is real wage inflation**
- **Still proving challenging to rationalise why the US bond market refuses to discount inflation risk rather than disinflation risk**
- **Flooding in Northern Europe is a further reflection of global warming and a massive task at hand.**

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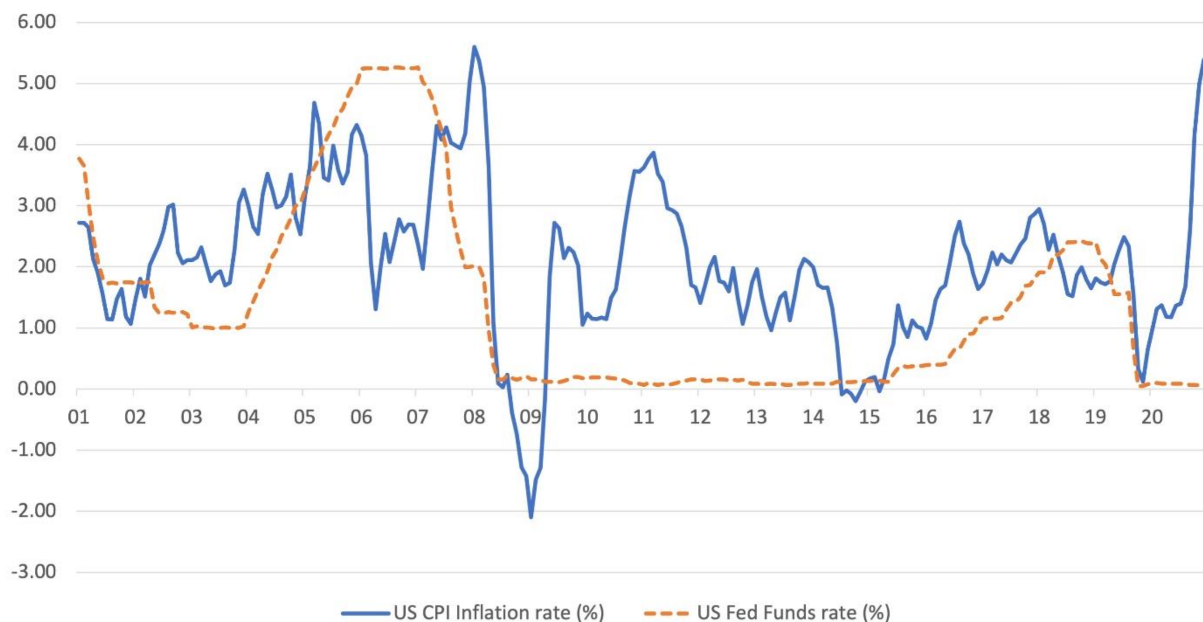
Inflation surprising everyone but the Fed?

Conventional wisdom six months ago was that higher inflation would prove transitory. Economists had then forecast that US inflation would peak around April/May. After another stormy set of inflation data from the US last week, inflation appears to have still not peaked, and there is less support for the view that it will prove transitory.

US inflation for June came in well ahead of expectations at 5.4% year-on-year; core inflation was at 4.5%. An analysis of the inflation data shows that we cannot dismiss it as just transitory. US economist and market watcher Dr. Edward Yardeni points out that over the past three months through June, the annualised headline and core inflation are running at 9.3% and 10.2%, respectively. The rise in inflation has occurred without any significant increase in oil prices or the cost of medical services. However, the basic elements of the consumer basket are witnessing a spike – food prices are up 6.4% quarterly annualised, clothing is up 9.0%, while household furniture and bedding is up 19.2%.

Chart 1: The Fed clearly doesn't believe that inflation will remain anything less than transitory



Source: Bloomberg

For the moment at least, the Fed maintains its mantra that inflation is transitory and that it will not change policy until it sees both inflation and near-full employment. To be fair, unemployment has some way to go, but inflation must be starting to worry the Fed. For a central bank, it is not just about generating inflation. It's also about convincing people in the economy that inflation will be sticky at or around their target. It seems mission accomplished as far as the latter is concerned. The bond market prices a breakeven 5-year inflation rate of 2.5%. However, consumers' one-year inflation expectations have hit 4.8%; three-year inflation expectations are at 3.6%; and the NFIB small companies' survey showed that 47% of business owners are raising their average selling prices – the highest reading since 1981.

There could also be a silver lining to the US inflation data – it encourages more people to take

up jobs and not sit on the economy's sidelines, thus bringing down unemployment. There are evident signs of wage inflation. Last week, US asset manager Blackrock announced an 8% increase in the salaries of 95% of its 16,500-strong workforce.

Bonds are discounting something other than inflation.
Despite the robust inflation numbers, the bond market has failed to react conventionally. Yields have not risen to reflect the rise in inflation. Indeed, much has been going on in the bond market that defies convention in this cycle, making comparisons with previous episodes of inflation treacherous. For one, the fact that the Fed has two policy tools – quantitative easing and interest rates – to play with leads to very different impacts on bond yields for a given level of inflation.

The US 10-year treasury ended last week at 1.30%, reflecting a drop of 30bps in yield over the previous three months. The period coincides almost precisely with the sharp rise in inflation. In real terms (that is, adjusting for inflation), investors are now facing the prospect of negative yields. Even in the corporate and high yield bond markets, nominal yields mostly fail to compensate investors for inflation.

How do we square the rise in inflation with the drop in the long-dated US government yields? The only possibility is that the bond market is discounting some hard landing and policy error combinations. For economic growth to be in sync with current yields, the view must be that there would be a material drop in GDP forecasts. We would have to see growth stall and then decline from its current run rate (in the US and globally) and inflation to recede quickly from current levels.

How likely is this scenario? It would almost certainly have to involve a policy error from the Fed, a spike in COVID that requires another sudden-stop policy response from governments, or some combination of these two factors. Looking simply at COVID, one could concede that new strains could still upset the current growth trajectory. However, initial statistics from countries with high vaccination rates are encouraging.

The other explanation for the low yields is that the market is pricing a high probability of a Fed policy error. Let's assume that inflation stays at these elevated levels. In that case, it could be that the bond market is factoring in a scenario where the Fed will lose its nerve and go on a quick tightening spree with higher policy rates instead of just tapering bond purchases and beginning a slow rise in official interest rates. In that scenario, the consensus US GDP growth forecasts, which are at 6.6%, would require a collapse to less than half of that. Economists viewed pre-COVID US GDP at 3.5% to 4% with no alarm at all, so peg the error-scenario outcome around 1% to 2%. At the same time, there would have to be a precipitous drop in domestic inflation to around 1.5% levels. Clearly, the scope of the purported error is enormous.

The answer: not very likely. From this perspective, bond yields are no more logical than they were before. There does not appear to be a catalyst to cause a sudden spike in yields to levels above 2%, at least in the immediate future, but the risk is that it will still happen at some point.

Unlike the Fed, not everyone is comfortable with the spike in inflation. Chile joined Brazil

and Mexico in increasing interest rates by 25bps last week. The Bank of Korea sounded hawkish in its message to the markets last week, indicating a rate rise as early as in August, maybe on the cards. The market expects Russia's central bank to raise rates by 100bps this week. Meanwhile, UK is the only G7 country that may be minded to tighten earlier than others. The UK has always been prone to more inflation pressure than others, and a sizeable upward surprise in inflation this past week will exert some pressure on the Bank of England to suspend its quantitative easing.

European floods show the urgent need for capital to fund the technology to rein in greenhouse gases.

The past week's devastating floods in Europe have yet again brought global warming back into focus. The unfortunate loss of life and the scale of the flooding were of biblical proportions. The German insurers' association, the GDV, said that storms, floods, heavy rain, and hail experienced in Germany this year could make it one of the most damaging since 2013, which saw losses between EUR 8bn and EUR 9bn. However, estimates are continuing to rise. It was a sad irony that this past week the European Union proposed a raft of climate policies aimed at slashing the bloc's planet-warming emissions by 2030.

However, no one economic bloc can solve the problems alone; it will take an almighty global effort. Last week, a new study published in the journal Frontiers in Sustainable Cities showed that just 25 cities contribute over 52% of the world's urban greenhouse gases. China accounts for 23 of the top 30 cities. Top polluters continue to be countries that are industrially advanced. Data from 2018 showed that the United States had 18.44 metric tonnes of greenhouse gas emissions per capita compared with Germany’s 9.72 mt and China’s 8.87 mt.

We continue to be struck that the scale of the investment in reducing greenhouse gases is small relative to the focus on companies improving their ESG scores. Investment in technology that reduces carbon footprints is the direct route to a better and greener world, not just promoting companies that have corporately changed direction and can hit some green agenda.

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