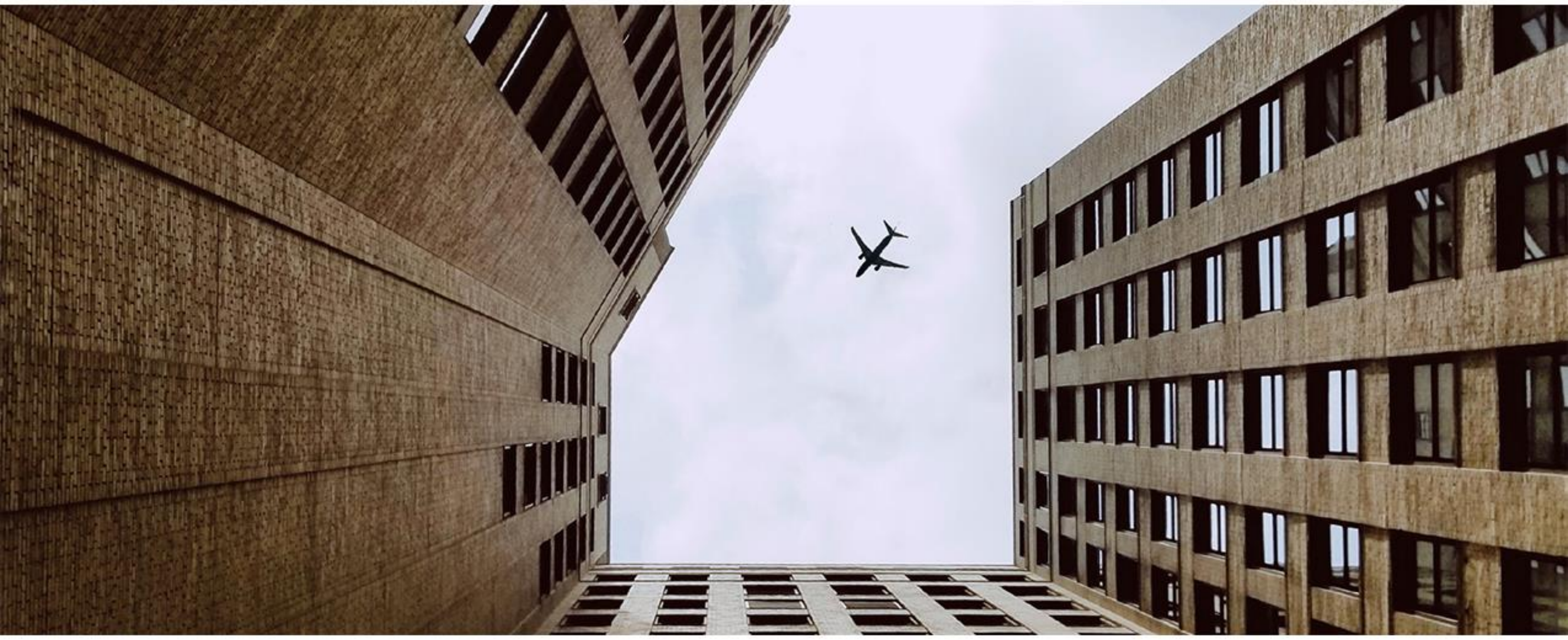
THE BIG PICTURE OF GLOBAL ECONOMICS

GLOBAL CIO WEEKLY **BY GARY DUGAN**



February 9, 2022

Has the Penny Dropped?

- **Watch out for US inflation data this coming week it could be ugly.**
- **US labour market data was strong but full of unprecedented revisions.**
- **The 5.7% annualised increase in US hourly wages adds to the inflation risks.**
- **US 10-year yields look set to push through 2.0%**
- **US small caps look oversold relative to S&P 500.**
- **The ECB is turning hawkish as it shuns its patience with inflation.**

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The data flow shows that inflation is persistent and a far greater challenge to central bank policy than many had envisaged. For many a developed market central banker, the penny seems to have finally dropped!

The Federal Reserve is already giving the impression of taking seat-of-the-pants like decisions. At the central bank, decision making has become quite reactionary or, as the Fed would perhaps like to term it, “nimble”. Such decision making can only become even more reactionary if the data driving the decisions is volatile. The Fed has two targets: price stability and full employment. Inflation is quite frankly off the charts and hazardous to predict. Given that scenario, one might hope that employment statistics would be more predictable, but last week’s employment report was one of the most unfathomable in living memory for pure statistical complexity.

The US nonfarm payrolls report released by the Labor Department surprised the markets with a net addition of 467,000 jobs, which was four times the consensus expectations and twice the highest forecast. There was a whole host of statistical adjustment to the data that economists are trying to decipher. Take the January headline number of 467,000 new jobs… well, the actual number was -2.8 million. Urgh? The gap is ‘explained’ by seasonal adjustments. However, that was the biggest seasonal adjustment on record.

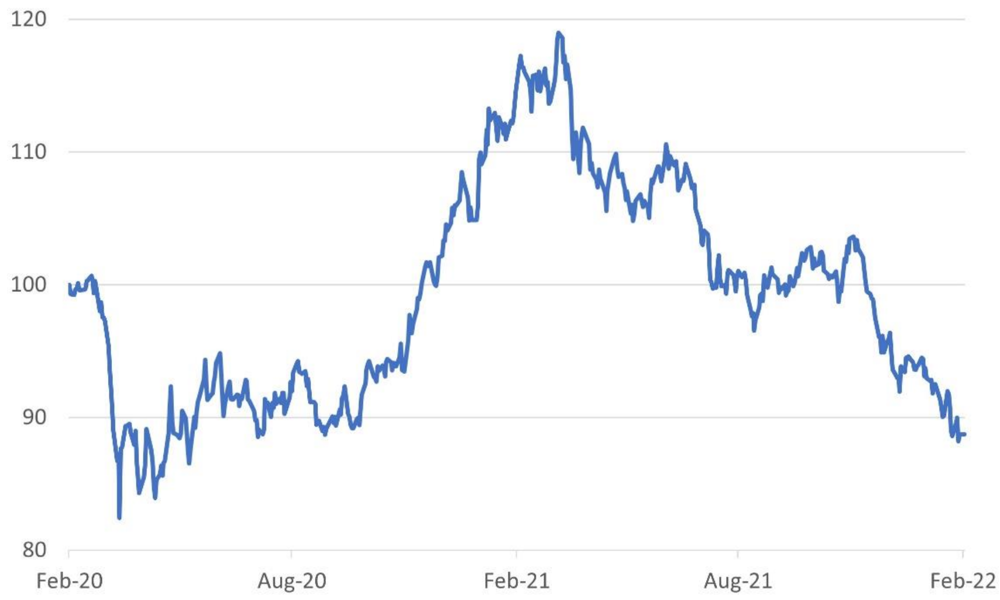
The volatility and complexity of the US labour market data beg the question as to how the Fed is supposed to decide about the appropriateness and objectivity of its monetary policy when the quality and accuracy of the data is so open to question.

This week, the US bond market will likely see more volatility with the 10-year and 30-year bond auctions, and inflation data. The market expects headline inflation to rise to 7.3% from 7.0%. We see risks to the upside on the forecast. Energy prices have remained sticky at their recent highs. Rent increases are still in a phase of boosting headline inflation. And some pipeline service sector price inflation is in double digits; last week, Amazon announced a 15% increase in the subscription rate for Amazon Prime.

US 10-year government bond yields ended last week at 1.90% and look set to breach the psychologically important 2.0% mark in the upcoming trading sessions. Besides the big surprise on new jobs, there was also a 5.7% annualised increase in hourly earnings. For good reasons, the Fed watches this number with some trepidation: it is a good indication that workers are gaining the upper hand in wage negotiations. But it also implies that labour supply is getting tighter, and workers are feeling the pinch in their wallets from higher prices – of rents, food, and energy. It may be hard to root out wage inflation once it becomes embedded in the system via consumer expectations. Under these circumstances, the 10-year yield shooting past 2% looks on the cards, having somehow not happened yet despite the constant surge in inflation.

The US small companies equity index looks oversold. In recent weeks, the US small caps have witnessed some marked underperformance. Since October, the Russell 2000 Index has fallen about 10% relative to the S&P500. The underperformance seems even more surprising given that the Russell 2000 has a relatively low weighting in growth/tech stocks. The recent timing of the underperformance appears to be coinciding with the Omicron-induced slowdown in the domestic economy; however, as the economy re-emerges from the impact of Omicron, there is the potential for the re-opening trade that previously sent the small cap sector's relative performance soaring in late 2020.

Chart 1: US small-cap sharply underperformed the S&P500 in recent months



Source: Bloomberg

After a week of big upward surprises on both consumer price and producer price inflation, **the European Central Bank abandoned all pretence of patience with inflation. It signalled a clear shift in stance—from dovish to hawkish.** Headline CPI was 5.1% in January, well ahead of consensus estimates of 4.4%, and an increase from December's already high 5.0%. It is noteworthy that the staggeringly high PPI number of 26.2% year-on-year was in line with expectations! Twelve months ago, PPI was close to zero year-on-year. The sharp increase reflects the rise in energy goods and raw materials prices.

Concrete steps from the ECB are in the offing: The ECB made it clear that it will use the next meeting in March to reassess the path of monetary policy, given the clear presence of inflation. In previous messages, the stated policy has been that it would only consider a lift-off in policy rates once it had completed its asset purchase program (APP). Markets now expect the APP to end by Q3 this year, given that the ECB will accelerate its tapering. Such a course of action boosts the prospects of the first ECB rate hike before the end of 2022.

Market expectations have shifted in tandem. Higher inflation together with the ECB's hawkish tilt has caused the interest rates futures market to discount an expected increase in policy rates this year, with a further three or more hikes next year. Given the risk of inflation turning out to be more resilient than the ECB's projections, the threat to this outlook is skewed towards more hikes, and not less.

Bond yields are reacting everywhere. As an example, in Germany, Bund yields reacted to developments by bouncing above zero conclusively. After spending several years in the negative territory, the 10Y Bund rate ended last week at 0.2%, up from zero at the start of the week and from as low as -0.4% in December.

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