



IS INFLATION ON THE HORIZON?

In the past, the difficult task after a recession was stimulating demand. However, today it is the supply side which is creating the new challenge. The supply chains we once took for granted have been interrupted which has led to disruption across international markets and we are now facing the consequences. There are plenty of examples of how the supply of trade related materials like container and freight vessels, construction timber, steel and insulation materials and of course microprocessing chips have been disrupted which has led to reduced supplies and increasing prices. As a result, the six million dollar question is ‘is inflation on the horizon?’

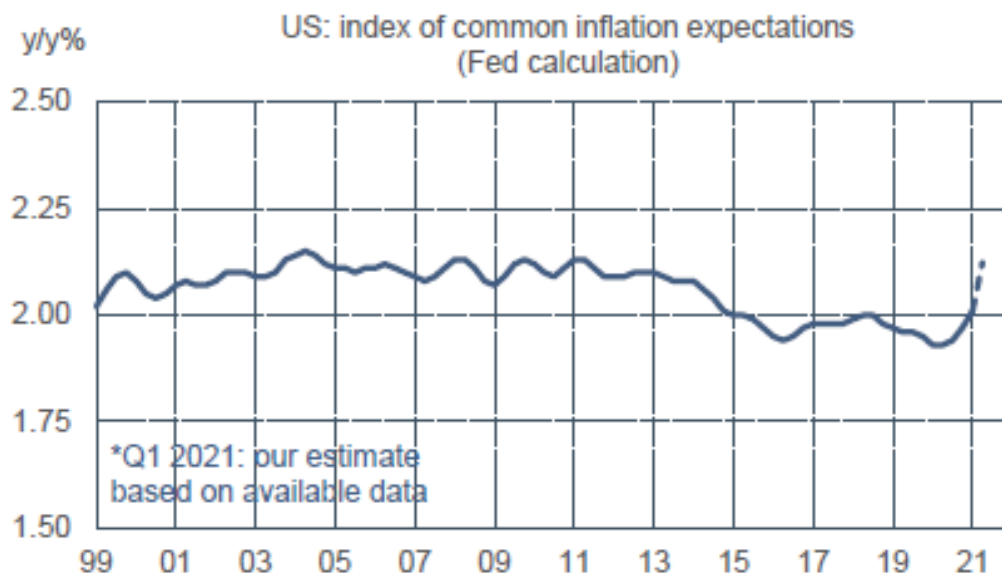
Another question which is on many pundits minds is will this disruption be a temporary blip on the international horizon or will have a medium to long-term impact? We are not talking about a post-war shortage here, where productive capital and the labor force has diminished, on the contrary. The pandemic has disrupted the production system based on a seamlessly operating globalized supply chain. In all likelihood a return to pre-pandemic normality does not seem imminent, putting upward pressure on prices and salaries.

This is how we might summarize the debate on inflation in the US today.

Two hypothesis: we at the dawn of a structural change putting decades of low inflation behind us caused by a massive fiscal and monetary stimulus by the US government or; is it just a limited phase of an overshoot of price adjustments often seen during an economic recovery?

Are the recent figures on inflation in the US a confirmation of a trend or an overreaction to exceptional circumstances? If you look at the CPI there was a strong year on year rebound at +4.2% and the PPI rose +6.2%, but these figures do not answer the fundamental question.

The CPI and PPI numbers are accelerating inflation expectations but not for the short-term but for the long-term. However, historically, these measurements are usually correlated to past inflationary figures and do not represent a valid prediction for future price rises.

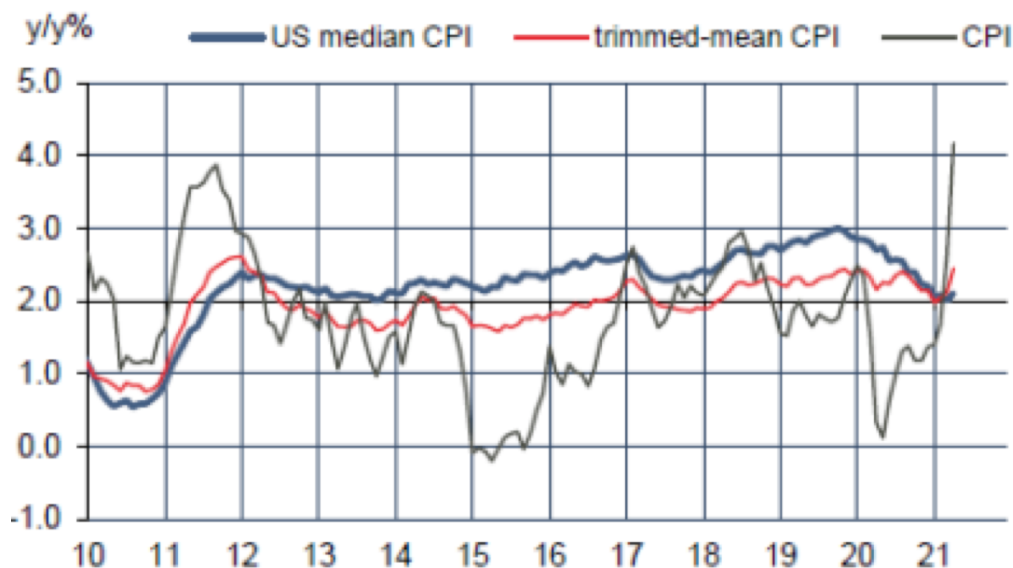




In spite of public expectations, the Fed has its own synthetic index to “predict” future inflation. It eliminates short-term volatility making the Fed index inert and keeping it just over the 2% comfort zone of the Fed.

US: metrics of inflation expectations							
		Latest	2019	2011	Correlation with CPI (%)		
					past	present	future
Survey-based measures	Consumers						
	_5-year ahead (U. Michigan)	3.1	2.4	2.9	50	38	8
	_1-year ahead (Conf. Board)	6.7	4.6	5.9	-1	8	-48
	_3-year ahead (NY Fed)	3.1	2.6	-	47	35	1
	Firms						
	_Manufacturing* (ISM + Fed surveys)	4.9	2.2	3.0	-5	56	-6
	_Services* (ISM + Fed surveys)	3.6	2.7	2.1	13	56	6
	_1-year ahead (Atlanta Fed)	2.8	1.9	-	16	54	7
	Experts						
	_5-year in 5-year (SPF, Phil. Fed)	2.2	2.3	2.4	26	-18	5
_5-year in 5-year (SPD, NY Fed)	2.2	2.2	2.3	-4	22	21	
_5-year in 5-year (SMP, NY Fed)	2.2	2.1	-	53	21	-38	
Market-based	_Inflation swaps 5Y in 5Y	2.5	2.1	2.9	38	12	0
	_Inflation breakeven 5Y in 5Y	2.3	1.9	2.5	11	20	-12
CPI		4.2	1.8	3.1			

The basic findings of the table above is that one should never mix the adjustment of relative prices and the general movement of the inflationary level . Some items are more volatile than others. It is established that the variation of volatile items does not have repercussions cuss on the general price level, and consequently the index will ignore it . This is why underlying inflation is calculated after trimming (arbitrarily) energy and food.



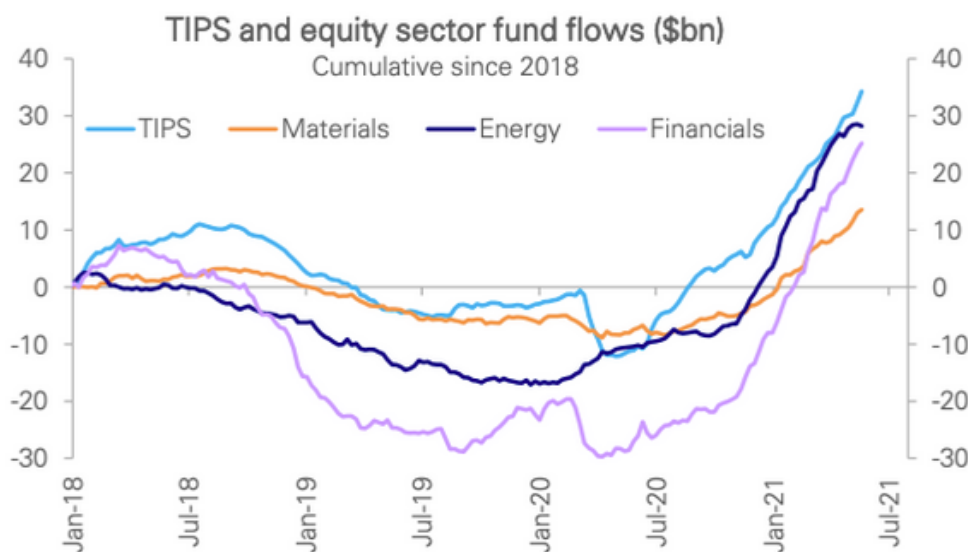
However, this is not the whole story. The pandemic, the resulting lock-downs and eventual loosening/lifting of the pandemic restrictions created havoc across whole fields of economic activity, with prices changing wildly. Even if you organize all of the price variations within the CPI and consider a median component by cutting highs and lows, you should be able to ascertain the price tension in the sectors directly affected by the pandemic like transport services or the leisure industry. Whichever way you look at the chart even this (blue line) is not a particularly good indicator.

FED wants somewhat higher inflation

An eventual change in monetary strategy is an important element in the debate over inflation. Henceforth, the FEDs long target for inflation is slightly over 2% p.a., to compensate for soft price pressures in the past. The forward view is a bit blurred as to duration and amplitude, but we are certainly far from a critical point and when they might have to act. There is no certainty that current price pressures are durable (non-transitory) and therefore the FOMC has no reason to adjust policy yet.

Deutsche Bank strategists, led by Parag Thatte, published a note on Friday 21 May, indicating investors continued to pour money into both equity and fixed income products (see chart below) that are perceived as inflation winners: TIPS, energy, materials, and financials.

Figure 1: Strong fund flows into beneficiaries of higher inflation



Source : EPFR Global, DB Asset Allocation



Energy, materials, and financials are also well represented in cyclical trades, value trades, and reopening plays. Infrastructure expectations are up and so are commodity prices. More economic growth, paired with higher rates, feeds into the financial system. Much of the money moving into this sector is coming from investors lightening up on their tech investments.

To follow

This month revision of national economic accounts (27) should confirm previous estimates of GDP Q1 2021 at +6.4% QoQ annualized.

To date, the nowcast models put economic growth between 5% and 10% for Q2. It will have to be prudently evaluated, but no doubt that at this level GDP growth has overpassed pre-pandemic level.

Sources : Thomson Reuters, Bloomberg, Google, Oddo BHF Securities

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