Focal Point

US inflation: rising, not soaring

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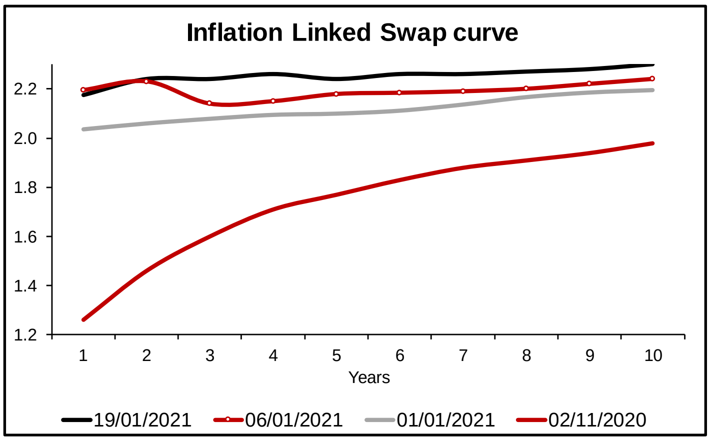
- Fears of an acceleration in inflation are showing up in financial markets, as the incoming Biden administration is set to boost domestic demand at a time when progressing vaccination will contribute to a sustained increase in consumption.
- Price spikes on supply bottlenecks are possible. Base effects will boost yoy inflation in Q2 by given the collapse of prices in spring last year and the delayed impact of the fiscal stimulus. While temporary, this may fuel inflation concerns.
- That said, we see core PCE (currently at 1.4%) closer to much not higher than the 2% threshold by end of 2022, with economic slack and high unemployment keeping a lid on wages. The Fed will then continue its accommodative policy, maintaining its focus on supporting the labour market recovery and willing to tolerate a temporary inflation overshoot.
- Following a continued rise over the past 10 months, the path for US inflation expectations is likely to moderate going forward. That said, inflation uncertainties will remain high, keeping the risks tilted towards a higher inflation risk premium.

Since the beginning of the year financial markets have started increasingly to worry about a sudden and strong return of US inflation. Behind this stands the double boost from domestic demand coming from the widely expected reopening of the economy in spring and the large fiscal stimulus the incoming Democratic administration will most likely deliver. While worries about a spike in inflation and the unpleasant consequences for financial markets are grounded, we expect inflation to trend up only gradually, broadly in line with what happened in the recovery after the Great Financial Crisis. In what follows we will sketch our baseline outlook for inflation amid the (mostly upside) risks, with a recap on the latest Fed views on the issue.

Markets bet on a quick reflation

Financial markets have reacted quickly to the radically new outlook for the US economy that emerged since autumn and are now discounting a rather quick reflation. News on vaccine efficacy and availability led to a marked improvement for the short/medium term perspectives for domestic demand. Afterwards, the results of the Georgia Senate election (Jan 5) drastically reduced the hurdles the incoming Biden administration will face in delivering a substantial fiscal boost, and markets quickly underscored its potential in terms of extra price pressures.

Risk assets are largely underpinned by a scenario of non-inflationary growth. Stronger than expected inflation, triggering a sharp rise in bond yields, might then have a disruptive impact on financial markets. It would also leave the Fed in an awkward position as the need to maintain an accommodative stance in order to bring about full employment and guaranteed favourable financial conditions might conflict with the need to curb rising inflation before it gets engrained into expectations.



Arithmetic will lift annual inflation in Q2…

However, to assess the likelihood and risks of such a scenario it is worth recalling first the current situation and then what we know about inflation dynamics.

The latest readings of most measures of underlying inflation (table on the next page) continue to show the scars from the Q2 drop in demand and remain way below the Fed's target. The question is then how fast can inflation go back into the vicinity of the Fed target.

Over the next few months, and especially during Q2, we will see a quick, mechanical, recovery of annual inflation rates as the effect of the drop in prices experienced at the beginning of the pandemic one year ago fades from the inflation calculation. This will occur roughly in the same period when the immunisation of a large enough part of the population should allow the partial unwinding of lockdown measures and after oil and other commodity prices have staged a strong rebound.

Underlying Inflation Measure	% chg yoy Dec-19	% chg yoy Latest*		
Core CPI	2.2	1.6		
Median CPI	2.8	2.2		
Trimmed-Mean CPI	2.4	2.1		
Sticky CPI	2.9	1.9		
Core PCE	1.6	1.4	(green)	Within target range
Market-Based Core PCE	1.5	1.3	(blue)	0.25 - 0.50 ppt below
Trimmed-Mean PCE	2.0	1.7	(purple)	> 0.50 ppt below
Cyclical Core PCE	3.2	3.0	(yellow)	0.25- 0.50 ppt above
Cyclically Sensitive Inflation	1.8	2.0	(red)	> 0.50 ppt above

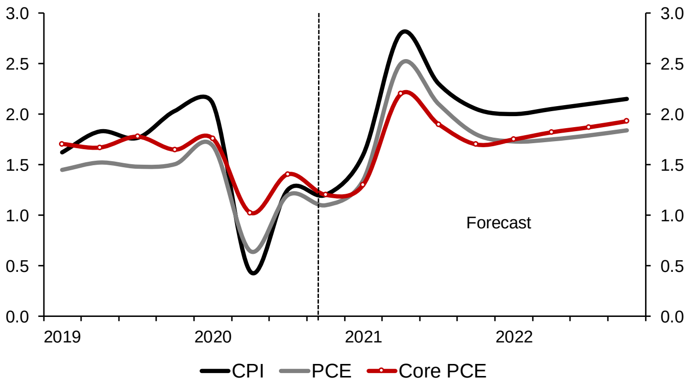
* December for CPI data, November for PCE Source: Atlanta Fed

This will result in pent-up demand, which may become particularly strong in the short term, given the unprecedented level of resources consumers were forced to hoard by the lockdown (in November the personal savings rate was 12.9%, against a pre-pandemics average of around 7%). At the same time, domestic demand will be supported by the new fiscal boost the incoming administration will deliver from the end of Q1 onwards. Given the slim Senate majority, the announced US$1.9tn will not be reached; our conservative estimate is at least US$ 1tn lifting GDP growth to around 6%, with a substantial upside risk. Fiscal aid will provide income support for poorer households who were not able to save and will allow state and local governments to restart spending. Therefore, we expect core PCE inflation to rise to 2.0% yoy during spring, with risks tilted to the upside. On top of that, bouts of volatility in some sectors, further blurring the picture, can be expected as spikes in demand may not be matched immediately by supply (e.g. tourism and travel).

…but afterwards a gradual reflation will follow

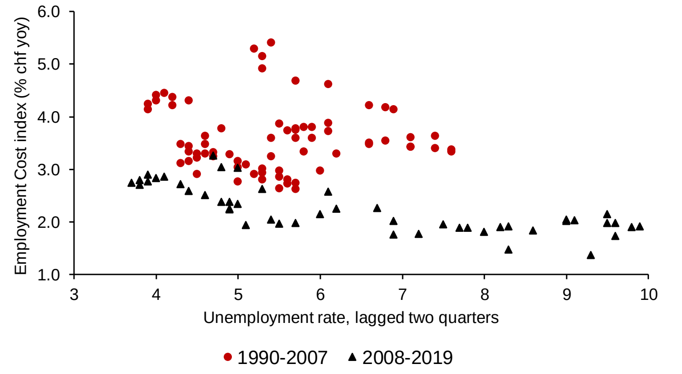
After that inflation should moderate again, before returning to a moderately upward path as the labour market continues to heal and domestic demand grows steadily. All in all, we expect core PCE inflation, the measure most relevant for the Fed to end 2022 at just below 2%.

Inflation



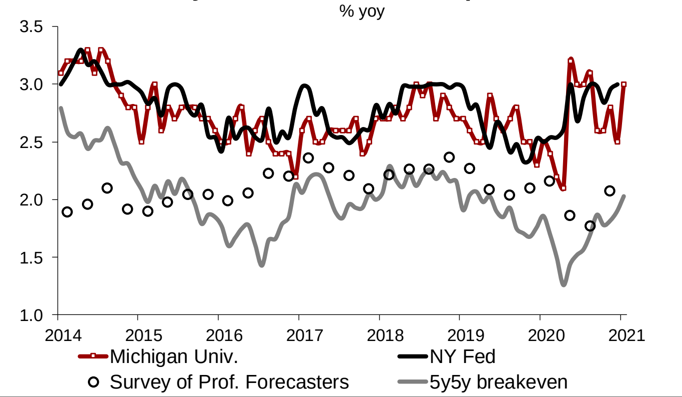
In the ten years between the through of the global financial crisis and the Covid-19 outburst steady growth was accompanied by only very moderate inflation. In 2019, when the unemployment rate hit a 50-year low (3.8%), core annual PCE inflation fluctuated within the 1.6% to 1.9% range. The low response of wages to labour market conditions was instrumental to that. Now we do not see many forceful reasons for a steepening of that relationship. Moreover, evidence for the last couple of years before the Covid-19 crisis shows that a "hot" labour market brings about an increase in the participation rate, something that Chair Powell has often cited as a big priority. This would further reduce the inflationary impact of high demand for workers.

Unemployment-wage relationship



Research shows that inflation expectations are playing an increasingly important role in pricing decisions. Most of the action taken by the Fed recently was aimed at avoiding that household and corporates took low inflation for granted. Conversely, expectations of escalating inflation would affect pricing decisions, increasing price pressures. The latest evidence from surveys (which incorporates only in part the news on the fiscal stimulus) provides a mixed picture but does not flag yet big risks of an upward slide. Household expectations, while very volatile, are merely on the rise back to the 2018-2019 levels, in part due to disruptions in the supply of basic goods and services. Economists' expectations are increasing too, mostly a correction of the slump following the sharp contraction in activity during the first part of the year; it is important to notice that disagreement among forecasters remains much higher than normal, highlighting the exceptional uncertainty of the outlook. Finally, news on fiscal policy has accelerated the recovery in inflation breakevens, back to the early 2019 level.

One-year ahead inflation expectations

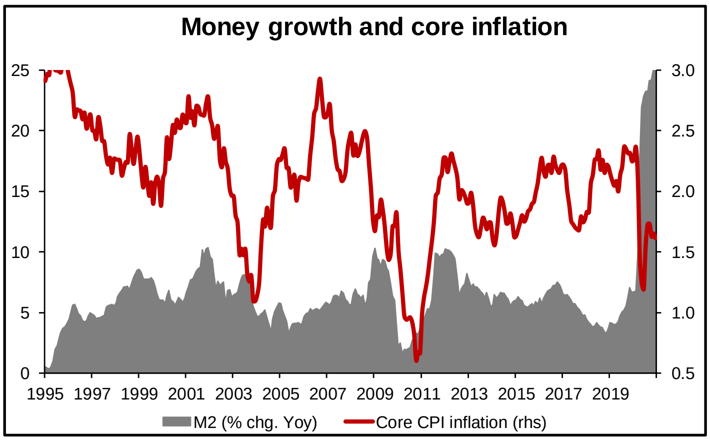


Risks to the forecast are on the upside

Our forecast assumes that the pandemic will not change dramatically the structure of the economy, at least in the short-to-medium term. Some policy-induced changes that could drive inflation up, such as reshoring of some parts of the supply chains and tighter labour market regulation (including a rise in the federal minimum wage) rank high in the incoming administration's agenda, but it will take time before they have a material impact on the economy.

For the next couple of years, upside risks are bigger than downside ones. An unsuccessful vaccination campaign and/or a recrudescence of the virus would lead to another recession, dragging down realized and expected inflation and would in our view trigger further action by the Treasury and the Fed. Risks on the upside are related to demand-supply imbalances, the labour market and the impact of monetary accommodation. Demand pressures from the possibility to spend hoarded income may turn out to be too strong for the productive capacity of firms, which have been weakened by several years of low investment, especially the non-technology ones. A slow catching up in the rebuilding of capacity could lead to a long spell of above-target inflation, strong enough to drive up expectations. A similar, but potentially more dangerous dynamics could occur in the labour market; if long term unemployment does not fall fast, the ensuing hit to skills and motivation may lead people to drop out of the labour market. A reduction in the pool of available and adequately skilled workers would lead wages and prices to respond more quickly and strongly to lower unemployment. Ramping up capital expenditure is normally faster than motivating and retraining workers, so we see the labour market as a more binding constraint to activity. Labour supply and long-term unemployment are then key variables to watch.

Finally, the post-2008 experience casts several doubts on the theory that "inflation is always and everywhere a monetary phenomenon", as the massive increase in central bank liquidity was followed by an only mild rise in inflation. This was due to several factors like structural changes in labour and goods markets and the successful steering of expectation by the central banks, but also because the Great Financial Crisis hit the banking sector especially hard. Most of the money the Fed created during the crisis ended up in excess reserves (due to tighter regulation and the Fed starting to pay interest on reserves) and did not contribute much to credit to the private sector. The current situation differs not just because of the much higher increase in money growth, but also because credit activity has not been affected and because Fed flows to the private sector thanks to the massive direct transfers to households and firms – which are likely to strengthened by the Biden administration.

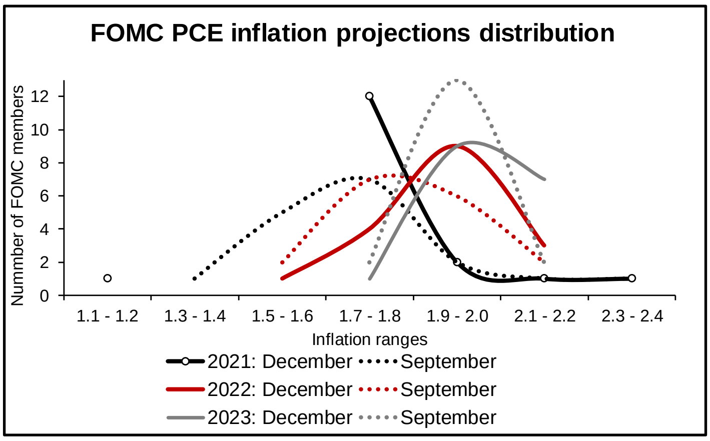


Regulators have several tools to prevent excessive credit creation, but money supply could be another factor tilting the demand supply balance in favour of higher inflation in the short medium term, warranting a close look at credit aggregates over the coming months.

A weaker dollar could be another tailwind to inflation. Our baseline forecast contains a moderate depreciation (3% to 3.5% for the broader index on a twelve-month horizon) but this will not be strong enough to exert a very significant pressure on retail prices.

Fed does not see significant risks

Market worries on higher inflation are not reflected in the most recent statements by FOMC members, as the focus remains on allowing financial conditions to be favourable to job creation. In the December meeting expected PCE inflation was revised slightly up; risks of spiking inflation are mostly related to short term volatility as activity gets back on track in 2021.



Most of the attention remains on the disinflationary pressures still emanating from the labour market and technology enabling higher competition. PCE inflation trending up to 2.5% over the coming months would be perceived as healing of the economy, and would be tolerated, especially under the new average inflation targeting framework. In case of a bigger increase, Powel and other FOMC members signalled that the Fed has the tools to intervene. Much will then depend on the causes of higher inflation. If it was demand-driven it should be accompanied by faster attainment of full employment, and this would reignite speculation about a quicker reining in of the stimulus. If, on the contrary, it was due to supply bottlenecks (like a higher equilibrium unemployment rate) which also affect adversely trend growth, monetary policy would not have many options.

Summing up, recent evidence does not point to a quick build-up of inflationary pressures and we stick to our forecast of a very gradual convergence of PCE inflation to the 2% target. The volatility that we expect in the process should not lead to a material upward revision of expectations. Nevertheless, we acknowledge that upside risks prevail, mainly due to the possibility that labour supply (and more broadly productive capacity) has been permanently lowered by the pandemic and struggles to keep up with the surge in demand we expect from Q2 on. Moderate inflationary spikes, with PCE inflation rising to 2.5% yoy or just above would be tolerated by the Fed. Upside risks to inflation and a more tolerant central bank create upward pressures to bond yields, but it would take a very big revision in expected inflation to trigger a yield rise capable of materially worsening the outlook for riskier financial assets.

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