Ready for the summer?

91 – 17 May 2021

Key points

- US consumer prices for April surprised to the upside but it's difficult at this stage to assess the depth of inflationary pressure. The Fed is unlikely to be swayed. In the Euro area the European Central Bank (ECB) needs to answer a key question very quickly: what to do with the current pace of Pandemic Emergency Purchase Programme (PEPP).

Last week US inflation for April came out as a shock, with both headline and core indices surprising to the upside. What we had been bracing for is materializing: consumer prices are moving significantly up but distinguishing the signal from the noise is going to be extremely difficult for several months (at least). Indeed, much of the acceleration in core inflation could be traced to a few components standing for less than 5% of the index. Yes, bottlenecks are pushing prices up – and by a lot – in sectors such as motor vehicles, but these supply issues (e.g., the global shortage in microchips) do not reflect endogenous overheating (at least not yet). Wages surprised to the upside as well, but there again, the signal is polluted by statistical artefacts.

The picture is too blurry to sway the Fed away from its dovish message. The surge in inflation needs to be put in perspective: the "price gap", i.e., the difference between the actual price level and where it should be if inflation had been in line with the Fed target, is large after almost 10 years of sub-par inflation. Maybe the ongoing pick-up is precisely what is needed to finally "re-set" long-term inflation expectations to a pace consistent with the Fed's target. The risk of course is that this goes too far. The Fed is going to be under a lot of pressure this summer as the price hump is likely to continue. Yields should go up in this environment.

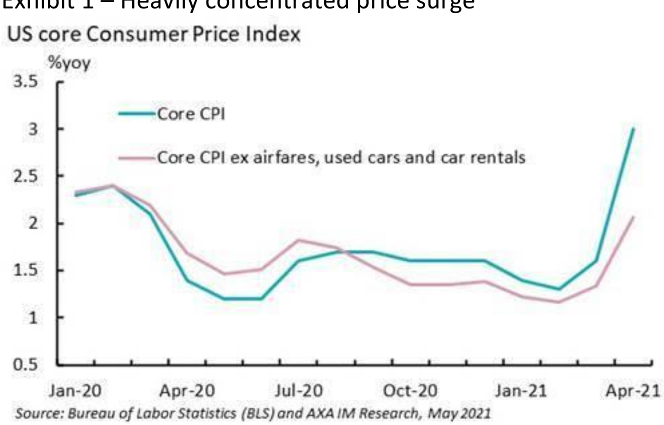
The Euro area's accumulated "price gap" is much wider than in the US, which supports those at the ECB Council now pushing for explicitly tolerating some overshooting in the future. But that issue is unlikely to be addressed before the central bank completes its strategy review. The immediate question to solve is how to mitigate any additional contagion from the US to the European bond market in the months ahead. The acceleration in the pace of the PEPP has not been conclusive so far. We note that at least one prominent sell-side house is now expecting the ECB to reduce its pace of buying at the June meeting. This would be risky in our view. It would run against the needed decoupling with the US and could push the euro higher. Some members of the Governing Council are ready to accept some tightening in financial conditions as a reflection of an improved macro outlook. Unfortunately, even if progress on vaccination is undeniable, the pandemic front remains uncertain, with countries such as Japan and Singapore extending their restriction measures, and the British Prime Minister mentioning the possibility to revise the country's reopening timeline because of the "Indian variant". The summer could be "interesting "on the markets.

Big inflation noise looking for a signal

Last week's highlight in the dataflow was obviously the massive acceleration in US inflation. The market was braced for a bumper figure, but both the headline and core CPI April prints (4.2% and 3.0%) came out significantly above expectations (at 3.6% and 2.3% respectively). The core inflation data in particular will fuel concerns about "runaway price pressure" which are getting pervasive in the commentariat. However, **we find little in the CPI details to help us decide whether the shock is transient of if something more sinister is lurking**.

Three components, which together stand for less than 5% of the weights in the core index, massively contributed to the surge (see Exhibit 1): used cars (+21%yoy), airfare (+9.6%), and car rentals (+81%). Excluding those items, core inflation would still be below the pre-pandemic pace. Current price changes in these sectors so obviously reflect the reopening of the economy or exogenous bottlenecks (e.g., the global shortage of microchips impairing the production of new cars) that forecasting their magnitude was always going to be a challenge and the "consensus expectation" was nothing more than a collection of shots in the dark. Looking ahead, given the still depressed price levels of some index components, there is some significant space for further acceleration which may not reflect a proper "endogenous" change in the inflation regime. For instance, even after the April surge, air fares are still 17.4% below their January 2020 level, so there's plenty to catch up still in the months ahead. We should therefore brace ourselves for more bumper prints of an essentially mechanical nature.

Exhibit 1 – Heavily concentrated price surge



The inflation hawks are drawing attention to wage developments, elaborating on the "labour shortage" which may be a key explanation behind the disappointing job creation numbers released the week before (see Macrocast #90). Indeed, average hourly earnings rose by 0.7% on the month in April, while the "consensus expectation" had them flat. **We don't think we will be able to read anything definitive in wage statistics for quite some time unfortunately. Indeed, unusually large composition swings are altering the quality of the data**. In the private services sector, "non-supervisory and production" workers normally account for roughly two third of the total workforce. However, in April, jobs of this nature rose by only 44K, against 282K in this sector overall. Such a discrepancy is very unusual but can have an impact on aggregate wage levels ("non-supervisory and production employees" make around 38% less than the other employees in the services). The composition swings upon reopening are intuitive: upon re-starting a business, employers would probably start by re-hiring managers and the most-skilled individuals.

So, what kind of information can we rely on to assess the inflation risks if there is so much noise in the data? In previous issues of Macrocast we have focused on survey-based measures of expected inflation. They can't tell us much about where inflation could be beyond 6 months, but at least they have been good predictors of short-term accelerations in consumer prices beyond the data noise. Last week we received confirmation that US households' inflation anxiety continues to rise. **5 years inflation expectations have hit another peak in May in the Michigan University survey, to 3.1%, the highest level since 2011.** Beyond extrapolating currently high inflation, perceptions of the central bank's reaction function also matter in the current circumstances in shaping consumers' views on

future price trends and given the Fed's constant reiterations of their willingness to tolerate a transitory overshooting, there is nothing much to stand in the way of strong expectations.

Stronger inflation expectations can impact actual price behaviour through several channels. First, entrenched higher expectations would normally trigger demands for more wage hikes, which could be passed to consumers in the current context of strong demand. Second, if consumers start believing the acceleration in prices will last, while interest rates paid on their deposits don't rise, rationally they should speed up the disbursement of their accumulated savings to "beat inflation" and protect their purchasing power. Such reversal in their savings behaviour beyond the mechanical impact of reopening would add to the current demand pressure on already strained supply chains, fuelling more price increases. Third, since consumers seem to be expecting higher prices anyway, retailers could more easily choose to pass the rise in their input costs to their final prices. Note that "inflation contagion" often stems from the "relative price illusion". Consumers impressed by significant hikes in the price of some key items may be less sensitive than usual to small rises on other items, allowing retailers to lift aggregate prices without suffering too much of a backlash on their sales volumes.

We continue to think that **there is no "smoking gun" yet which would make it certain inflation is on the rise in durable manner in the US, but it is equally obvious to us that a rational analysis of available information would tilt the distribution of probability in that direction.** Still, the commentariat in our view is split in two overly extreme positions. One camp – currently losing ground - seems to believe that nothing has changed with the pandemic: we are stuck in the 2012-2019 configuration and beyond short-term spikes, inflation is still very much a "dead monster" so that bringing it back to 2% is going to be a herculean task. The other thinks this is 1972 again and that we are on the brink of an uncontrollable inflationary spiral.

There is a third possibility though: after the current shock, inflation could merely stabilize around the central bank's target. We have often made the point in Macrocast that the post 2012 "inflation undershooting" owed a lot to adaptative behaviour. In clear, low inflation, triggered by a series of exogenous shocks and lagged cyclical effects from the Great Financial Crisis, was increasingly seen as permanent by economic agents, to the point that we thought it would take an exogenous shock in the other direction to normalize expectations. This is possibly what the pandemic may have brought: a temporary but powerful reminder that inflation will not necessarily slowly converge to zero on trend. Still, merely solidifying 2% inflation would be a major change, which would be consistent with a further rise in nominal yields, and of course there is no reason why this third scenario should "magically" prevail.

Indeed, two symmetric hurdles need to be avoided for this to materialize. On the one hand, policy makers, and central banks in particular, must not panic and withdraw support too quickly; on the other, they will have to steer their stimulus towards some soft landing and avoid making structural decisions – for instance in the realm of wage bargaining – which could make an inflationary spiral possible. In the US, it is the latter risk which at the moment dominates, in our opinion.

The European inflation chasm

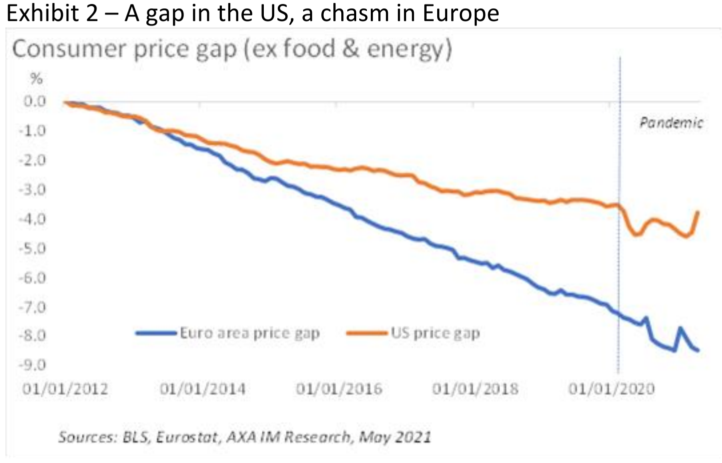
Before we discuss the policy stance, we need to put the ongoing surge in US inflation in perspective. The Fed is not precisely following a price level targeting strategy, but it is still the inspiration for "average inflation targeting", e.g., allowing periods of overshooting to "compensate" for periods during which inflation has been sub-par. In Exhibit 2 we calculate an illustrative "consumer price gap", i.e., the difference between the actual consumer price level (for core items) and where it should have been if inflation had been equal to the Fed's target all along (here we impose 2.45%, to take into account the usual spread between the Fed's preferred measure of inflation, the core deflator for Personal Consumption Expenditure, which should grow by 2%, and core CPI). It takes a judgment call to decide *when* to start calculating the gap (it's one of the limitations of the price level targeting framework). Here, we start in Q1 2012, which is the last time core inflation in the US managed to settle above 2% for several months in a row. **Irrespective of the starting point, what is in any case undeniable it's that the additional price gap triggered by the pandemic was almost entirely plugged by April 2021**.

In principle, the Fed should maintain its accommodative stance for long given the size of the gap accumulated in nearly 10 years before the pandemic even started. The Fed never committed to "plug" the entirety of any price gap. At the current growth rate in core consumer prices, it would take until mid-2027 to bring the gap to zero. The probability that the Fed could sustain a magnitude or duration of overshooting consistent with plugging the gap is extremely low, in our view, given the risks of losing control of inflation expectations and financial stability issues, but fortunately Average Inflation Targeting – the Fed's current framework - is a much looser and discretionary stance.

The right quantum of overshooting should be the one necessary to settle inflation expectations back to the central bank's medium-term target, but there is no simple criterion to assess this. **Arguably, based on the recent surveys we discussed earlier, this has already been achieved in the US**. However, the FOMC will probably consider that the current jump in expectations needs to be confirmed once the mechanical effects of the reopening on observed inflation disappear, but we suspect they are going to be under a lot of pressure in the coming months. As the current "price hump" goes on through the summer, survey-based inflation expectations are likely to continue rising, fuelling concerns that the Fed is behind the curve. The majority of the FOMC around Jay Powell seem to be quite unified around their message of patience – which we think will be reiterated in the "FOMC minutes" out next Wednesday - and they have strong points to make, in particular a possibility the US goes through a soft patch once Biden's emergency stimulus fades, especially if the investment package currently under negotiation with the Republicans is smaller than expected. But equally, "genuine" wage hikes – i.e., beyond the mechanical effects of the reopening – may have started triggering proper cost-push inflation in the system by then, while on the legislative side we continue to monitor projects such as the PRO Act (Protecting the Right to Organize), which would raise union power in the US private sector, currently still held off at the Senate level.

The Euro area is in a very different situation. Although consumer prices have started to accelerate there as well, this is far from enough to offset the further widening in the inflation gap triggered by the pandemic crisis. In April 2021, the consumer price level (excluding food and energy) was only 0.9% above February 2020, which means that the deviation from the level consistent with the ECB's target increased by another 1%.

Exhibit 2 – A gap in the US, a chasm in Europe



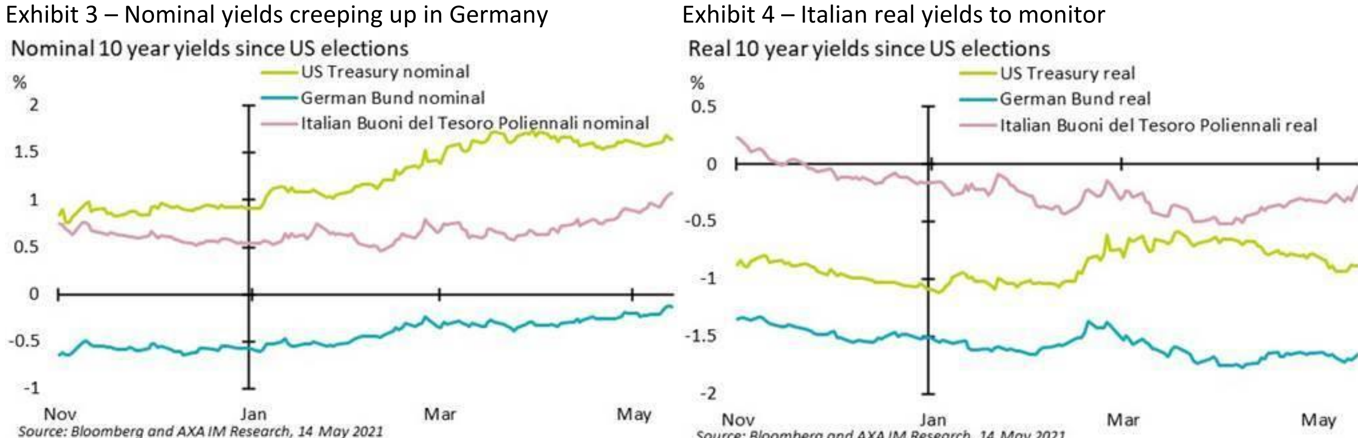
"Average Inflation Targeting" is even easier to justify in the Euro area than in the US given the magnitude of the "price gap" there. We used the same starting point for the calculation as for the US, since late 2011/early 2012 is the last time core inflation reached 2% year-on-year in the Euro area as well. Olli Rehn put this option on the table again two weeks ago. Rather than all out AIT, we would expect the Governing Council on the occasion of the strategy review to change the definition of the ECB's inflation target, removing the "below" from the "below but close to 2%" current wording, thus providing a "soft nod" to tolerating some overshooting.

The main problem for the ECB at this stage lies less in the possibility that inflation expectations settle too high too quickly, as in the US, than in a difficulty to effectively protect the European bond market from US contagion. According to the latest minutes of the Governing Council, Isabel Schnabel started the customary review of market developments which opens the meeting with the notion that "Euro area government bond yields had decoupled

from US Treasury yields”. This no longer aptly describes the market situation: while US long-term yields have stabilized around 1.6% in nominal terms, German yields have been catching up slowly, and Italian yields have been rising more significantly to cross the symbolic 1% threshold again last week (see Exhibit 3). The ECB’s upgrade to the spending pace of the Pandemic Emergency Purchase Programme does not seem to work that well.

Exhibit 3 – Nominal yields creeping up in Germany

Exhibit 4 – Italian real yields to monitor



The minutes confirm that the Governing Council is increasingly focusing on ex ante real interest rates. On this front, core yields have not edged up (see Exhibit 4), which would be reassuring for the ECB, but this does not hold for Italy where real rates have been rebounding since the end of April. The hawks may consider that this reflects the improvement in investors’ confidence in the looming economic rebound, including in usually fragile member states. If left unchecked though, this could gradually impair the ECB’s capacity to deliver on what has possibly been its most efficient transmission channel in this crisis: making the continuing fiscal support financially manageable.

In his latest interview in Le Monde, the ECB’s chief economist was precisely asked about this and we find his answer, if indirect, quite interesting: *“In the United States, the ability of the government to finance any scale of deficits is not questioned. If we did have more of a fiscal union in Europe, the ability of European governments not to worry about how to finance deficits would be a lot stronger”.* At the time Italy is “maxing out” its capacity to leverage the Next Generation funding, this reflects in our opinion a certain level of concern on these issues in at least some quarters of the ECB, even if Lane chose not to sound alarmist by suggesting the periphery is in a much better shape than 10 years ago since no gaping current account deficits are making the funding of local fiscal deficits more difficult. True, real rates in Italy are still negative, but at the risk of repeating ourselves, Italian trend economic growth itself is barely in positive territory: it does not take much to tilt the sustainability equation in the wrong direction.

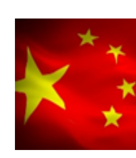
We noticed that Goldman Sachs changed their call last week and expect the ECB to reduce their pace of buying at the June meeting. We are not convinced at this stage. it is precisely in the next few months that the peak of the “inflation hump” should be hit, fuelling even more anxiety and further upgrades in US inflation expectations. Further upward pressure on US yields is likely to ensue, with potential additional contagion to the European markets. Reducing the pace in June would be “brave” in our view, with the ECB running the risk of being forced into a U-turn at the September meeting. It would make more sense to wait and see how the market deals with a complicated summer for the Fed before altering the current course.

“Are we getting there yet?”

Another reason which would make a reduction in the pace of buying in June adventurous in our view is that visibility is still far from full on the pandemic front. Progress on vaccination continues in Europe, but we can’t know for sure if we are not going to meet the same difficulties as in the US to cover the “last mile” as the resistance of anti-vaxxers starts emerging. Against this background, outside the Euro area flare-ups continue to appear here and there, forcing a resumption of restrictive measures. Last week the Japanese government extended the state of emergency to three more Prefectures and tough social distancing has been re-imposed in Singapore. In the UK, the

Prime Minister is preparing minds to the possibility his reopening schedule could be revised given the rising number of "Indian variant" cases in the North West of England.

In his interview, Philip Lane said that *"we are now, in May and June, at an inflection point. From now on, the economy will be growing quickly, but from a subdued level".* It is our baseline as well, but the balance of risks remains firmly tilted to the downside, and this should be another reason not to alter the current PEPP course in June already. The summer will be "interesting".

Country/Region	What we focused on last week	What we will focus on in next weeks
	• CPI inflation rose to 4.2%yoy – a 2008 high – with core rising to 3.0% – a 1995 high. PPI inflation also rose sharply to 6.2% • Closure of Colonial oil pipeline and Mississippi cargos added to short-term supply angst • Yields jumped to 1.70%, but retraced • Retail sales were flat in April after a 10.7% surge in March – supportive of Q2 spending • Inflation expectations remained elevated	• FOMC minutes for April's meeting published, look for discussions on removing "some time" language and signs of raising IoER • Empire and Philadelphia Fed surveys for May, expected to remain in solid territory • Housing data including starts and sales, look for impact of falling mortgage demand in recent months • Jobless claims have continued to improve • PMIs preliminary estimates for May
	• EC forecasts raised the outlook for Eurozone activity to 4.3% and 4.4%, from 3.8% previous • ECB minutes for April meeting, provided little guidance for key decisions to be made in June • Ge ZEW survey rose by more than expected, expectation highest since 2000 • EZ industrial output soft at just +0.1%mom	• PMIs for Euro area (May): manu expected to remain robust, services to improve • Second estimates of Q1 GDP for Euro area, pre lest -0.6%qoq • Final estimate of Euro area inflation (Apr), pre lest 1.6% and 0.8% (core) • Ge PPI inflation for April, monitoring gains
	• Q1 GDP mildly firmer than expected at -1.5%qoq, but firmer 2.1% rise in March boosts prospects for Q2. We now forecast 6.4% 2021 • Total new cases flat, but 1.3k in Indian variant (0.5k last week) with surge in North West • RICS hse price survey at highest lvl since 1988, sharp rise in demand, with no supply response	• UK lifts restrictions further from Monday • CPI inflation (Apr) expected to rise sharply, we see upside to 1.4%yoy consensus • Labour market release (Apr/Mar), furlough expected to keep unemployment at 4.9% • Retail sales – BRC signalled large monthly gain again in April, after march's +5.4%mom
	• Government extended State of Emergency to 3 more prefectures (total 9) until end May • Economy watchers survey fell back further than expected in April as restrictions tightened	• Q1 GDP prel est, expect contraction (consensus -1.2%) following +2.8% in Q4 • National CPI (Apr) expected to mirror fall in Tokyo, dip to -0.5%yoy from -0.2% in March • Preliminary PMIs for May
	• Inflation pressure continues to rise with the PPI reaching a 3-year high on rising commodity prices and base effects. The pass-through to CPI is limited by falling food prices • Credit growth eases on weak short-term loan growth and corporate bond issuance	• April activity data to show improved sequential growth in consumer spending, industrial output and investment, but yoy growth would have eased
	• Q1 GDP released for ID (-0.7%yoy), MA (-0.5%yoy) and PH (-4.2%yoy) • Given many parts of Asia continue to see rising new daily cases, governments are re-imposing and/or extending lockdown restrictions • BSP expectedly remained on hold	• CB meeting: Brazil, Indonesia, Taiwan, Turkey

Upcoming events		
	US:	Mon: Empire State mfg sur (May); Wed: FOMC minutes; Thu: Phili Fed index (May), Jobless claims, Leading index (Apr); Fri: Mfg PMI, Serv PMI (May)
	Euro Area:	Mon: It HICP (final, Apr); Tue: EA GDP (Q1); Wed: EA CPI (final, Apr); Thu: Ge PPI (Apr); Fri: EA Comp PMI (flash, May), Ge, Fr Mfg&Serv PMI (flash, May)
	UK:	Tue: Unemployment (ILO, Mar); Wed: CPI (Apr); Thu: CBI Industrial Trends Survey (May); Fri: GfK consumer confidence (May), Retail sales (Apr)
	Japan:	Tue: GDP (prel., Q1); Wed: IP (final, March); Thu: Private 'core' machinery orders (Mar); Fri: CPI (Apr)
	China:	Mon: Fixed asset investment (Apr), IP (Apr), Retail sales (Apr)

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