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CENTRAL BANKS AT A TURNING POINT ?

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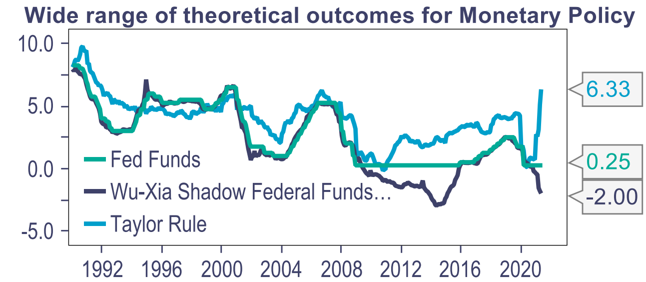
Over the last two months, inflation has surged to levels unseen in decades.This spike had been expected by market participants, as it is mainly linked to base effects. Yet, even though we agree that these levels should be mostly transitory, we continue to believe in the reflation trade and think that Central Banks are walking a fine line where it is crucial that they maintain their credibility. The Fed may therefore end up being more hawkish than what the market currently expects.

Inflation figures have spooked investors lately, especially in the US where headline inflation shot up to 5%, the highest in a quarter of a century. Recent data, such as the prices paid component of the ISM, stand at levels last reached during the 1970s oil shocks. Supplier delivery times are at their highest ever, indicating ongoing pressures and bottlenecks. In Europe, the upward trend has been impressive too. The region moved from being in deflation at the end of last year to a 2% headline inflation figure in May.

For the moment, markets have brushed off this spike as transitory. Actually, we tend to agree with this scenario. Most of the jump is linked to commodity-related base effects that are likely to fade in H2. Our US inflation forecasting model indicates that even with oil prices remaing close to USD 80 per barrel, inflation may fall back towards 2.3% by 2022. Aside from rents, which could be trending upwards in the context of a housing boom, the key variable we are watching is wages. On that front, pressures are moderate so far, but anecdotal evidence does suggest that risks are to the upside.

Counterintuitively, Central Banks could be one of the risk factors to this relatively benign scenario. Indeed, we do see some arguments that could leave them behind the curve. Standard central bank reaction functions such as the Taylor Rate, which is an indication of where monetary policy rates should be, given the gap between realized inflation and growth relative to their target/potential, are already pointing to way tighter monetary policy. Of course, we all know that these indicators are flawed by the special nature of the current economic recovery, but this still underlines the high level of uncertainty policymakers are facing.



Source: Lyxor AM, Macrobond, Bloomberg

First, after years of fighting deflation risks, decision makers could have a large cognitive bias. In this context, the risks of tightening too early are deemed as being too significant to be taken. The two lost decades in Japan are a constant reminder of the hardship it is to try to exit deflation.

Second, monetary policy frameworks are currently being revisited to reflect a much higher tolerance to above target inflation figures. This is explicitly the case with the Fed's average inflation targeting framework (FAIT), but the ECB has also just adopted a symmetric 2% inflation target following its monetary policy review.

As a consequence, Central Banks now explicitly have monetary policy reaction function that could lead to an increased risk of an inflation overshoot. Combined with massive Keynesian stimulus programs and an economic boom, this could pave the way for a scenario where transitory inflation could become permanent. For the moment, we still view this as a tail risk, a scenario in which Central Banks would be forced into abrupt rate hikes, provoking an economic crunch recession and financial instability.

In this light, we tend to view the latest "hawkish" Fed meeting as extremely reassuring. We also believe that the reflation trade, which has recently been challenged by the potential downside risk linked to the rapid spreading of the Delta variant, is still valid. The sharp decline in long term yields (US 10 year below 1.25% beginning of July), does not look sustainable in our view.

It is crucial that the Fed manages market expectations. Providing support and gradually scaling back monetary accommodation remains key to economic growth. But this objective will progressively need to take into account the necessity to rein in an above trend inflation. By communicating on the possibility of rate hikes as early as 2023, the Fed started to anchor expectations and signalled it would not let inflation get out of control. This paves the way for a smooth rate hike path, one that creates a supportive environment for equity markets. With growth remaining strong, this could even translate into rate hikes coming sooner than currently expected by the market.

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