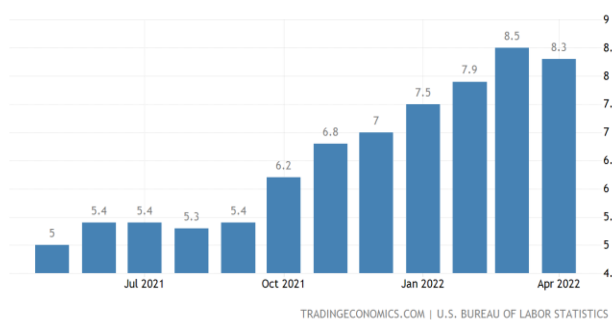
Neox Capital

Inflation Rebound – Follow up

Inflation data reaching 40-year highs has been front and center in the financial markets during the spring, making headlines almost daily. Being a crucial component in all fixed income valuations and thereby an important factor affecting FX and Equites as well, this is understandable. The re-valuation in the bond market was inevitable which we discussed in an article almost exactly one year ago, but the speed of the correction has surprised us.

Graph 1. *US CPI index since 1982*

However, if we look a bit closer, the current inflation wave is actually 3 different ones. We are now seeing the inflation impact from a combination of base effects after the covid shock, fiscal stimulus, and supply constraints.



Graph 2. *US CPI index, YoY.*

A large part of the realized inflation during the last 2 years stems from the supply-side and from goods with inelastic demand functions, like energy and food. This is the kind of inflation that Central Banks can do little about.

This is known as Cost-push inflation. Higher interest rates will not fix supply lines, or increase availability of energy where it is needed.

Good and Bad Inflation

From a Central Bank perspective, trying to maximize economic output without causing overheating, there are good and bad inflation.

Bear with me, this might get a bit technical but it's worth it.

Cost-push inflation is inflation stemming from higher input costs. Most notably energy, food, and raw materials. These are often the part of a company or households' consumption basket that is inelastic. I.e., it does almost not matter how much it cost, we as companies or households need to by roughly the same amount of it. Regardless of if crude trades at 50 or 100 we still need to heat our house and travel to work. A car company still need to buy steel, plastic- and electronic components irrespective of price, in order to produce cars. This mean that if prices on these input goods increases, there is less capital to spend on discretionary items and services. For the household, the disposable income after fixed costs falls.

Hence, certain types of cost push inflation have a quite similar effect on aggregated demand in an economy as a VAT. Higher cost push inflation is normally not a sign of an economy about to overheat. Quite on the contrary. It might actually in itself cool down economic activity, just like tighter fiscal or monetary policy.

Demand pulled inflation, however, is the kind of inflation Central Banks are allergic against. The presence of it in an economy is a classic sign of overheating and can lead to vicious wage-price spirals. This situation begs the action form the monetary authorities. The last few months we have seen more of this kind of inflation creeping into the numbers.

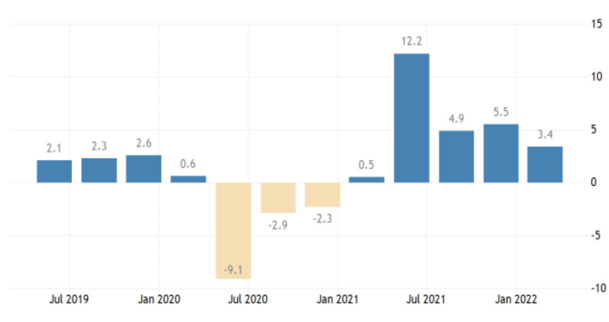
Additionally, just to complicate things, over time, there is a non-stationary feedback function(1) between the 2 types of inflation, but that is material for a more thorough research endeavor which we don't intend to embark upon here.

No matter where an inflation surge comes from it is always a serious headwind for financial assets.

Market expectations

With a Fed that already delivered a total of 75 bp hikes, and a market that currently pricing in 10 more hikes á 25 bp into the Fed Funds Futures curve, most of the tightening seems to be taken into account by now. Actually, there is probably a downside risk to the current hiking expectations and government bond yields.

Especially as we are seeing a deceleration in economic growth as well as in the employment statistics. Initial jobless claims have stopped falling this spring and even started to perk up a bit lately.



Graph 3. *US GDP annual growth.*

(1) The interrelationship between demand pulled and cost push inflation is not only unstable over time, but causality might also shift.

Graph 4. *US Initial Jobless Claims.*

A central bank tapping the breaks when the economy is accelerating is one thing. Then economic actors have time and slack to adjust to a tighter monetary environment. But now it seems increasingly as the Fed will be tightening into a slowing economy. This vastly increases the risk of a hard landing, i.e. rescission. So, the bottom line is that the landing strip for Fed to pull off a soft landing is quite narrow.

Much will depend on Powel and Lagarde and how they will evaluate the effects of rate hikes and QT as they go along. After all, Central Banks have a well-documented track record of going too far and or too fast when tightening monetary policy, which more often than not has led to economic contraction.

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