

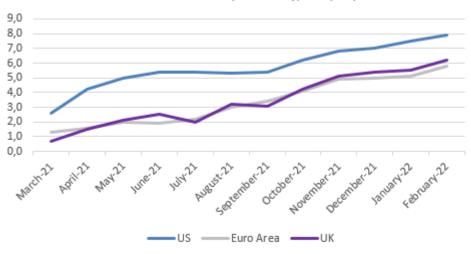
March 23, 2022

Inflation: the problem child of the global recovery



Because of shortages, supply-chain disruptions, unprecedented stimulus and the subsequent unleashing of pent-up demand, the Covid-19 pandemic gave birth to unruly inflation that monetary guardians are struggling to bring under control. Since economies began to reopen, inflation has been disobedient in the face of central bank targets which sit around 2% in the US, the Eurozone and the UK. Rampant inflation threatens to spoil what has otherwise been a spectacular recovery that is still going strong, as it is eating away at purchasing power. Already, inflation is becoming a political issue. In the US, it is viewed as the single most significant issue for Americans and there is broad cross-party support for getting it under control. Here in Europe, a cost of living crisis is kicking in and governments have stepped in to shelter households from rising costs (largely related to energy).

While there is little central banks can do to reign in supply-side inflation (which is being stoked by geopolitical tensions that could result in shortages of critical raw materials), politicians and the public alike are looking at them to do what they can do on the demand side to bring inflation back under control – without choking off growth.



Inflation rates (monthly, YoY, %)

Source: Bloomberg, BIL

While the central banks in the regions mentioned above acknowledge inflation as a risk, they are taking different approaches when it comes to handling this problem child.

The Bank of England has been quick to act, bringing interest rates right back to where they were before the pandemic came into play at 0.75%, with the fourth rate hike of its tightening campaign pencilled in for May. With that said, it might now be shifting stance: While some weeks ago, it solely focused on price inflation, last week's BoE meeting signalled a new focus on growth deflation. Higher commodity prices create both, and central banks have to choose which to prioritize.

Over the pond, after asserting that "transitory" inflation would come down of its own accord like

a kid that tires itself out, the Fed had to intervene with "tough love" after realising its "laissez faire" approach was too risky with inflation starting to become entrenched. It then proceeded to wean the market off of QE (purchases of Treasuries and mortgage-backed securities have now ended), before raising interest rates for the first time since 2018 at its March FOMC by 0.25% to 0.50%, and signalling hikes at all six remaining meetings this year. The Chair, Jerome Powell, went further on Monday, pledging a 50 bps move if needed in May - a move the central bank has not made since 2000. His warning did not go unheard and money markets now see the Fed funds rate at around 3% by September 2023, compared to 2.1% priced in at the start of March. Digging into the dot-plot, FOMC predictions of where rates will move in the next few years is unusually wide, suggesting Fed officials are highly uncertain about the future. The next move to prevent inflation running a mock is probably to begin shrinking the central bank's \$9th balance sheet.

The European Central Bank (ECB) is handling inflation with kid-gloves and at its March committee, conveyed that it was in no hurry to raise its record-low deposit rate even while it continues to unwind exceptional stimulus. When rate lift-off does begin, the ECB said the pace will be "gradual". While the Euro Area has weathered the Omicron variant quite well and is in full recovery mode with unemployment at a record low (6.8%), its economy is more exposed to the armed conflict in Ukraine. Lagarde herself has cautioned that the ECB action will be "out of sync" with that of the Fed in the foreseeable future in light of this and also because of the fact that the EU and US economies were at different stages in the economic cycle before the war broke out. In all, we expect that geopolitical tensions will delay rather derail the ECB's policy normalisation plans.

For investors, they key message is that the central bank comfort blanket is really being taken away this time, whether it be sooner or later. The question now is whether central banks can do so without causing a tantrum on markets or a hard-landing for the economy. In the US, Jerome Powell has pushed back on concerns that paring back policy support would cause a recession, citing episodes in 1965, 1984 and 1994 when the Fed slowed an overheated economy without prompting a sharp contraction. While equities have taken the Fed's tough love in their stride so far, its hawkish tone continues to drive the US yield curve flatter and the dollar higher; we might expect this to continue over the coming months.

In their portfolio construction, investors should consider the differing paces of policy normalisation. For example, the growing divergence between a more aggressive Fed and a more cautious ECB is widening the gap between US and German sovereign yields, and will also have implications at the style and sector level. As an example of how we are acting on the latter, we recently decided to bring our exposure to European Financials down to neutral while adding to our overweight stance on US Financials. When rates do start rising, Financials, particularly banks, will let out a collective sigh of relief after years of suppressed yields that pressured their operating model. The ECB's gentler pace (not to mention the greater exposure that European banks have to the Russian market) could hold back this segment in the near-term. However, it could also benefit other sectors that typically thrive in an environment of rising inflation like Energy and Materials.

Disclaimer

All financial data and/or economic information released by this Publication (the "Publication"); (the "Data" or the "Financial data and/or economic information"), are provided for information purposes only, without warranty of any kind, including without limitation the warranties of merchantability, fitness for a particular purpose or warranties and non-infringement of any patent, intellectual property or proprietary rights of any party, and are not intended for trading purposes. Banque Internationale à Luxembourg SA (the "Bank") does not guarantee expressly or impliedly, the sequence, accuracy, adequacy, legality, completeness, reliability, usefulness or timeless of any Data. All Financial data and/or economic information provided may be delayed or may contain errors or be incomplete. This disclaimer applies to both isolated and aggregate uses of the Data. All Data is provided on an "as is" basis. None of the Financial data and/or economic information contained on this Publication constitutes a solicitation, offer, opinion, or recommendation, a guarantee of results, nor a solicitation by the Bank of an offer to buy or sell any security, products and services mentioned into it or to make investments. Moreover, none of the Financial data and/or economic information contained on this Publication provides legal, tax accounting, financial or investment advice or services regarding the profitability or suitability of any security or investment. This Publication has not been prepared with the aim to take an investor's particular investment objectives, financial position or needs into account. It is up to the investor himself to consider whether the Data contained herein this Publication is appropriate to his needs, financial position and objectives or to seek professional independent advice before making an investment decision based upon the Data. No investment decision whatsoever may result from solely reading this document. In order to read and understand the Financial data and/or economic information included in this document, you will need to have knowledge and experience of financial markets. If this is not the case, please contact your relationship manager. This Publication is prepared by the Bank and is based on data available to the public and upon information from sources believed to be reliable and accurate, taken from stock exchanges and third parties. The Bank, including its parent, - subsidiary or affiliate entities, agents, directors, officers, employees, representatives or suppliers, shall not, directly or indirectly, be liable, in any way, for any: inaccuracies or errors in or omissions from the Financial data and/or economic information, including but not limited to financial data regardless of the cause of such or for any investment decision made, action taken, or action not taken of whatever nature in reliance upon any Data provided herein, nor for any loss or damage, direct or indirect, special or consequential, arising from any use of this Publication or of its content. This Publication is only valid at the moment of its editing, unless otherwise specified, All Financial data and/or economic information contained herein can also quickly become out-of- date. All Data is subject to change without notice and may not be incorporated in any new version of this Publication. The Bank has no obligation to update this Publication upon the availability of new data, the occurrence of new events and/or other evolutions. Before making an investment decision, the investor must read carefully the terms and conditions of the documentation relating to the specific products or services. Past performance is no guarantee of future performance. Products or services described in this Publication may not be available in all countries and may be subject to restrictions in some persons or in some countries. No part of this Publication may be reproduced, distributed, modified, linked to or used for any public or commercial purpose without the prior written consent of the Bank. In any case, all Financial data and/or economic information provided on this Publication are not intended for use by, or distribution to, any person or entity in any jurisdiction or country where such use or distribution would be contrary to law and/or regulation. If you have obtained this Publication from a source other than the Bank website, be aware that electronic documentation can be altered subsequent to original distribution.

As economic conditions are subject to change, the information and opinions presented in this outlook are current only as of the date indicated in the matrix or the publication date. This publication is based on data available to the public and upon information that is considered as reliable. Even if particular attention has been paid to its content, no guarantee, warranty or representation is given to the accuracy or completeness thereof. Banque Internationale à Luxembourg cannot be held liable or responsible with respect to the information expressed herein. This document has been prepared only for information purposes and does not constitute an offer or invitation to make investments. It is up to investors themselves to consider whether the information contained herein is appropriate to their needs and objectives or to seek advice before making an investment decision based upon this information. Banque Internationale à Luxembourg accepts no liability whatsoever for any investment decisions of whatever nature by the user of this publication, which are in any way based on this publication, nor for any loss or damage arising from any use of this publication or its content. This publication, prepared by Banque Internationale à Luxembourg (BIL), may not be copied or duplicated in any form whatsoever or redistributed without the prior written consent of BIL 69, route d'Esch I L-2953 Luxembourg I RCS Luxembourg B-6307 I Tel. +352 4590 6699 I www.bil.com.

