December 10, 2021

Taking the temperature on inflation drivers

2021 is the year when inflation came out of a prolonged slumber. It wasn't a slow, gradual awakening: It was an energized, caffeinated upsurge of 6% or beyond, whether one be standing in Berlin, Washington, Moscow or Brasilia. Central banks assured us it would be fleeting – a quick espresso shot of inflation in a post-pandemic context. However, price pressures are proving to be more persistent while broadening out; this is leading some to concede that the steaming hot inflationary brew in their hands looks more like a caffè lungo.

The US Federal Reserve has dropped "transitory" from its inflation vocabulary, the Bank of

Canada no longer refers to “temporary” forces pushing up prices, the Bank of England sees inflation “comfortably” above 5% next year and even Luis de Guindos, Vice President of the more dovishly-inclined ECB, this week warned that inflation will not go down as quickly and as much as the central bank predicted.

Economists and central banks, short of crystal balls, the ability to read coffee grounds or any other such forms of divination, can only make educated guesses about the outlook based on trends in the underlying drivers.

Price pressures have been fueled by a blend of factors with some of the most pertinent being: exceedingly high demand as economies simultaneously recovered from the pandemic (which even healthy supply chains would have struggled to satisfy), shortages (of labour, raw materials and certain components like semi-conductors), supply chain issues, elevated transportation costs and a global energy crunch.

The past fortnight has brought reassuring news on several of these parameters.

- Bottlenecks at US ports are improving. The twin ports of Long Beach and Los Angeles, which account for 40% of sea freight entering the US, have been working around the clock to address shipping container congestion. Back in October, tens of thousands of containers lingered on the docks waiting to be processed due to a shortage of warehouse space, workers and trucks. In response, the ports announced fees of $100 per container per day for carriers, to try and coerce them into speeding up processing times, thereby reducing backlogs and freeing up containers. Economic incentives seem to be doing the trick as, since then, lingering containers have fallen by 37% and the fleet of massive container ships loitering in San Pedro Bay has fallen from its peak of more than 80 in late October to 46.[i]
- Auto manufacturers are building partially-completed cars and storing them until semi-conductor inputs arrive. It’s reasonable that this may be the case for other consumer durable goods like gaming consoles and phones. This scenario suggests finished output could take off as soon as key components become available
- Growth in Britain's construction industry hit a four-month high in November, as supply-chain difficulties appeared to have passed their peak, according to Markit’s Construction PMI survey.
- The ISM Manufacturing PMI showed that in the US, the huge gap between supply and demand may be starting to narrow. Inventories sit at their highest levels since 2018, after companies raced to ensure they would be able to meet demand over the Thanksgiving/Christmas holidays. At the same time, order backlogs have fallen below the 12-month average.
- On the US labour market, the fact that the personal savings rate has fallen so precipitously would seem to bode well for the employment picture. When people deplete their savings, they need to go back to work.

However, like the circular stain left behind by an over-filled coffee cup, high inflation amongst these temporary factors is starting to leave a mark on more permanent drivers of inflation such as labour costs. If this continues unchecked, the risk is that it could ignite a self-fulfilling feedback loop whereby elevated inflation expectations lead to higher actual inflation. If so, rather than cooling in 2022 as central banks hope, inflation could become too hot to handle, calling for aggressive rate hikes that would probably stop economic growth dead in its tracks.

As such, in places where inflation has been red-hot for several months already, central banks are acknowledging that they can no longer wait for it to come down on its own accord. Already, in the US for example, consumer sentiment has dropped to a 10-year low on concerns about price pressures, according to the University of Michigan’s November survey. To address inflation, the Federal Reserve will now probably accelerate the pace at which it tapers it’s bond-buying program. A quicker taper will improve the Fed's ability to anchor inflation expectations and give it more flexibility to hike rates earlier than previously expected, essentially leaving the door open for a first hike as early as spring 2022.

Here in Europe, as of now there is little evidence of wage pressures mounting, but dissenting voices are growing louder with regard to the ECB’s dovish policy stance. The central bank will end its Pandemic Emergency Purchase Program in spring, but it is highly conflicted as to whether an additional volume of asset purchases should be added on top of the existing €20bn/month of regular Asset Purchase Program purchases thereafter.

Omicron: A curve ball

The Omicron variant could not have come at a worse time for central banks

An affogato? Signals about future inflation are a mixture of hot and cold

contemplating tighter policy. We still await full reports on the perceived danger of the new variant and the spectrum of potential outcomes is a wide one: Will Omicron dent demand and endanger the recovery – a scenario that would call for easier policies? Or, will it lead to new restrictions that exacerbate supply chain issues and stoke inflation further? This week, these kind of fears were in plain sight in the coffee market where futures prices reached decade highs: In an already-tight market, fear that Omicron would compel Vietnam, a key coffee exporter, to enact new restrictions led to a deluge of just-in-case orders which put a still-fragile supply chain under renewed pressure.

In all, signals about future inflation are a mixture of hot and cold. Next week's central bank meetings (the US Federal Reserve on December 14-15, the Bank of England and the European Central Bank on December 16) are eagerly awaited by investors hoping for more clues as to how the new variant may affect the future policy pathway.

As to our view, early signs signal that the Omicron variant may not be as much of a threat as originally thought, but uncertainty remains high until we have the epidemiological facts. Should it not represent a major plot twist, we still believe that inflation will become more manageable in 2022 as energy demand retreats after winter, Christmas shopping is ticked as "done" on the to-do list, and the global supply chain is slowly pieced back together, with in some cases, shortages leading to gluts in the second half of 2022. This, in our opinion, will usher in some kind of decaffeinated inflation: weaker but still very much present.

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https://www.latimes.com/business/story/2021-12-03/officials-say-the-ports-logjam-is-easing-but-numbers-dont-tell-the-whole-story

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