4X Global Research

Olivier Desbarres ▌contact@4xgr.com ▌+44 (0) 20 3811 0454

Fixed Income Research & Macro Strategy (FIRMS) – 2nd November 2021

Hawkish rates markets ahead of themselves

Our measure of global headline CPI-inflation rose further in September to 3.7% yoy but the 0.17pp increase was entirely due to the 0.27pp rise in CPI-inflation in developed economies to a 13-year high of about 3.9% yoy.

Headline CPI-inflation in EM economies was unchanged in September at about 3.3% yoy, with the fall in CPI-inflation in China and in particular India countering large increases in Latin America and Central Europe.

The consensus view is that the argument put forward by most developed central banks that high CPI-inflation will prove "transitory" has slowly but surely been losing credibility, even allowing for the definitional elasticity of "transitory". The Norges Bank, Reserve Bank of New Zealand, Bank of Canada and Reserve Bank of Australia have already taken action.

Two-year government bond yields have risen rapidly in the past month in most developed economies. This suggests that markets increasingly think that CPI-inflation will remain sticky at high levels for the foreseeable future and that (most) developed central banks will have little choice but to start to or further tighten monetary policy in the near future.

Analysts' consensus view, which we share, is also that the Fed will at its policy meeting tomorrow announce the start of QE tapering. Similarly analysts expect the ECB to announce a tapering of its asset purchases as its 16th December meeting.

However, analysts are less hawkish overall than markets. Our view is of a (partly) self-defeating prophecy, with the surge in short-end bond yields having de-facto resulted in a tightening of monetary conditions, which in turn reduces the odds of central banks hiking rates as aggressively as currently priced in by markets.

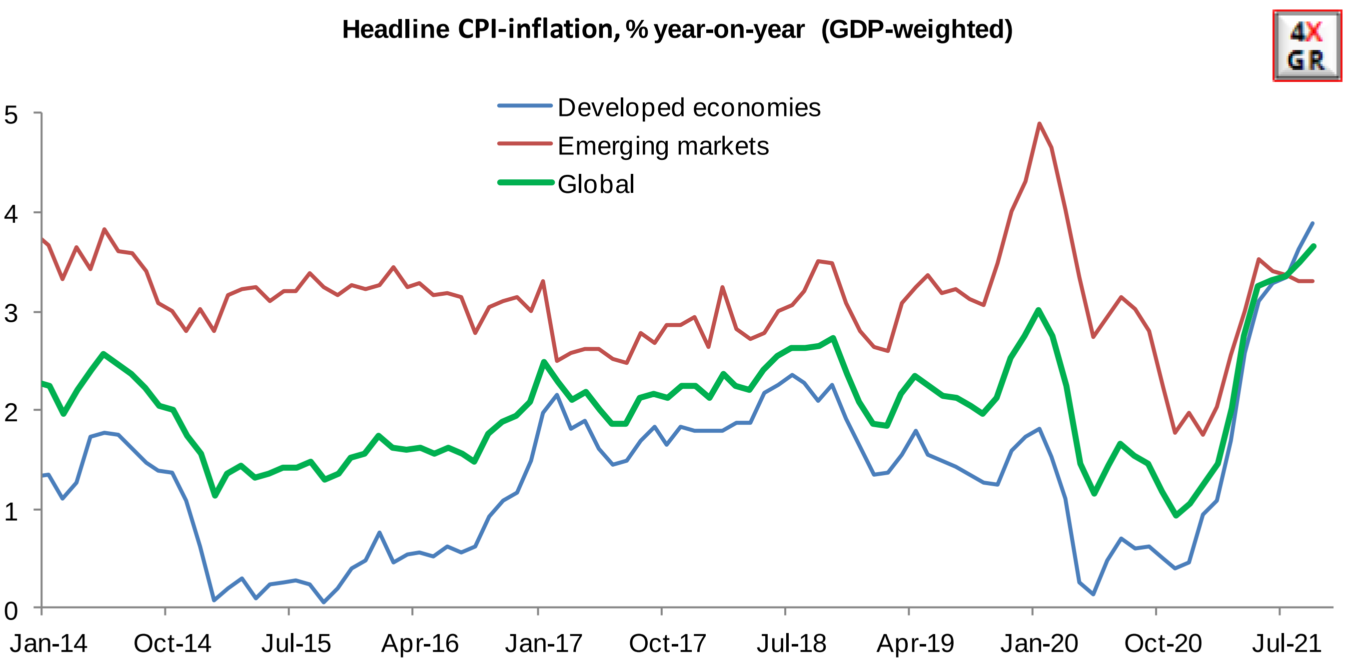
We expect the Fed at its meeting tomorrow to once again put some distance between the start of the QE taper and the start of the rate hiking cycle. While US household consumption is now running slightly above its long-term trend there is still a $1.1 trn "pandemic shortfall". Moreover, slower household consumption growth in recent months (albeit from a high level) has led to weaker demand-pull inflation and contributed to the fall in month-on-month PCE-inflation, in our view.

CPI-inflation rose further in September in developed economies, stable in EM

In Underneath the bonnet of "sticky" global inflation (12th October 2021) we noted that our measure of GDP-weighted CPI-inflation in 32 major economies (which account for over 90% of world GDP) had risen sharply since May 2020 in year-on-year terms and not just because of unfavourable base effects. Data for September confirm, as we had estimated, that global headline CPI-inflation rose further to 3.7% yoy (see Figure 1).

However, the 0.17 percentage point increase since August – the largest monthly increase since May – was due entirely to the 0.27pp rise in CPI-inflation in developed economies to a 13-year high of about 3.9% yoy, according to our estimates. Headline CPI-inflation in Emerging Market (EM) economies was unchanged in September at about 3.3% yoy. This stability was mostly due to the fall in CPI-inflation in China and in particular India countering large increases in Latin America and Central Europe.

Figure 1: Global headline CPI-inflation rose further in September…but a tale of two stories



Source: 4X Global Research, Eurostat, IMF, national central banks and statistics offices, World Bank

Note: GDP-weighted average of developed economies – Australia, Canada, Denmark, Eurozone, Japan, New Zealand, Norway, Sweden, Switzerland, United Kingdom and United States – and Emerging Market economies – Brazil, China, Chile, Colombia, Czech Republic, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Nigeria, Philippines, Poland, Romania, Russia, Singapore, South Africa, Taiwan, Thailand and Turkey (using IMF GDP weights).

Increasingly hawkish markets pricing in central bank monetary policy tightening

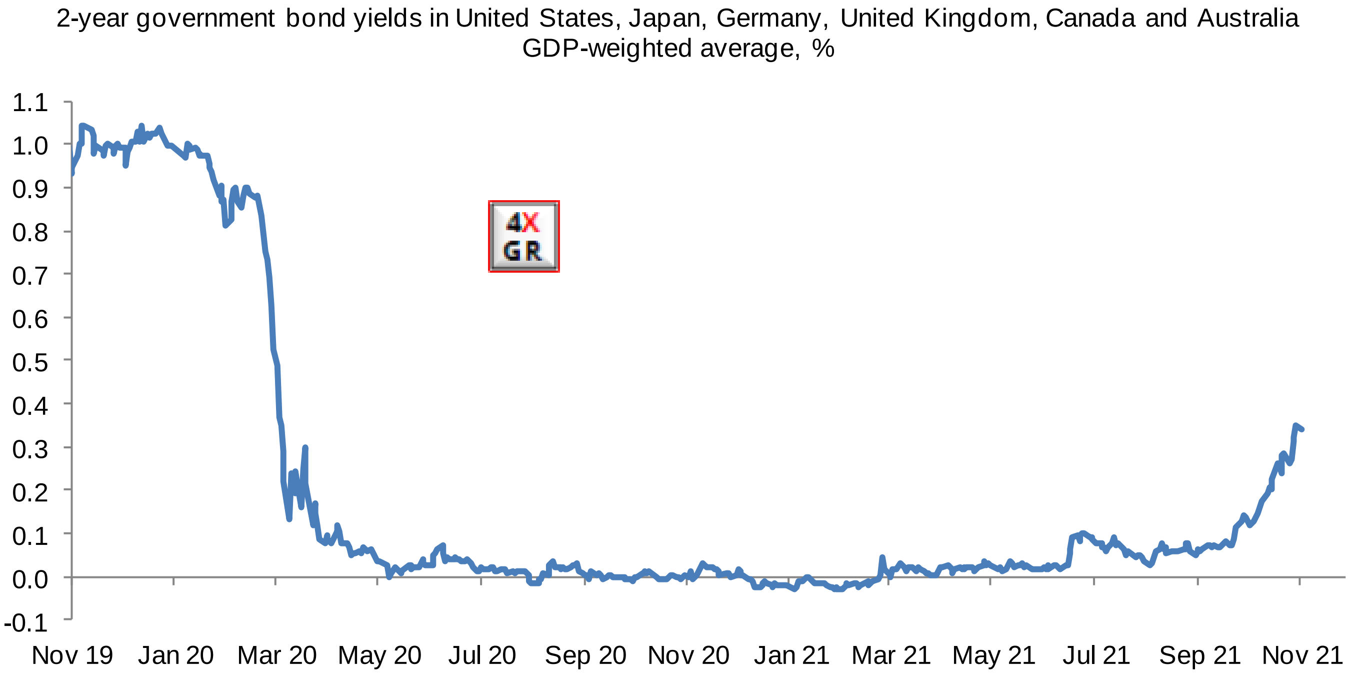
The consensus view is that the argument repeatedly put forward by the majority of developed central banks that high CPI-inflation will prove transitory has slowly but surely been losing credibility, even allowing for fact that the definition of "transitory" is somewhat elastic. A number of developed central banks have already taken action or at least implicitly acknowledged that tighter monetary policy will be required.

- The **Reserve Bank of New Zealand** and **Norges Bank** hiked their policy rates 25bp in respectively September and October.

- The **Bank of Canada** last week caught markets off guard by announcing it would likely start hiking rates in the "middle quarters" of 2022 rather in the second half of 2022 and that it would terminate its quantitative easing program with immediate effect (it will continue to re-invest proceeds from maturing bonds to the tune of CAD 4-5bn a month in order to keep its asset holdings constant).

- The **Reserve Bank of Australia** at its policy meeting today formally abandoned its 0.1% yield target for the government's key April 2024 bond. This was in line with expectations after yields had risen to 0.75%. The RBA said it would maintain weekly asset purchases of AUD 4bn until at least mid-February 2022 but implicitly brought forward to 2023 from 2024 its expected timing for the first (post-pandemic) rate hike.

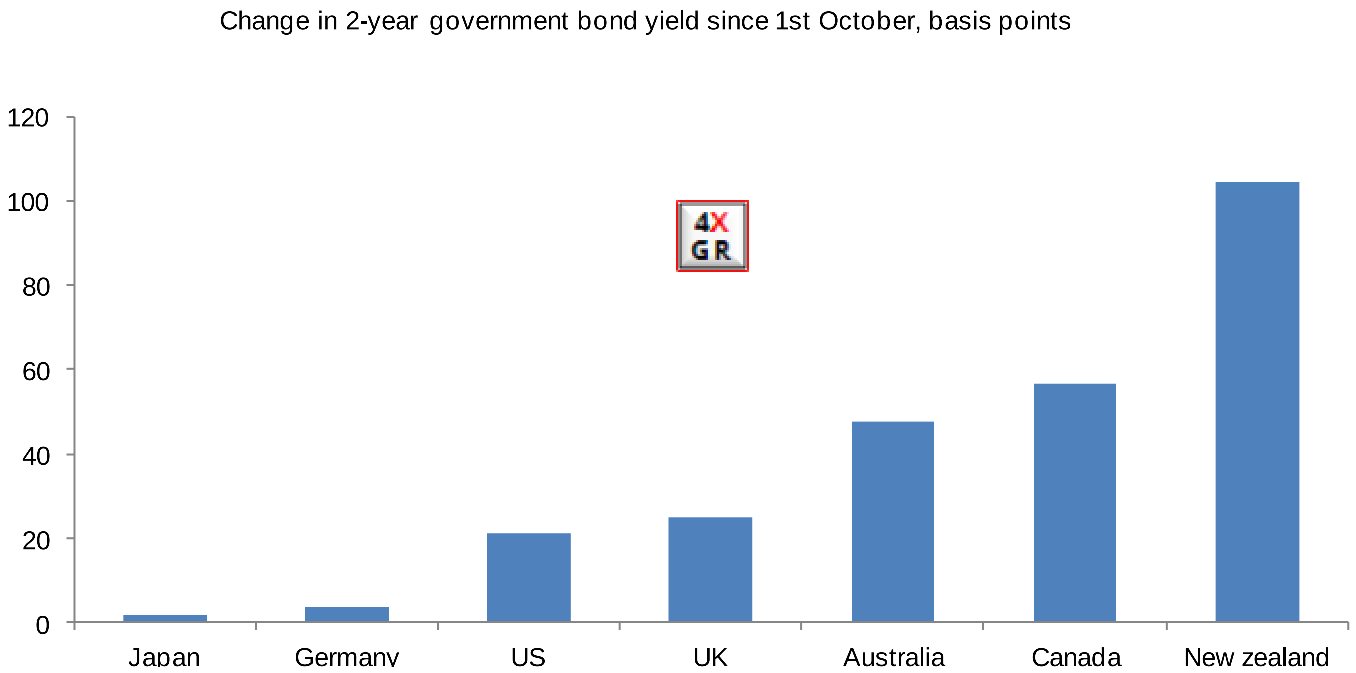
Figure 2: Short-end government bond yields in developed markets have risen sharply in past month…



Source: 4X Global Research, investing.com, IMF

Two-year government bond yields have risen rapidly in the past month in most developed economies (see Figure 2). The rise has unsurprisingly been most pronounced in New Zealand (see Figure 3). This suggests that markets are increasingly of the view that CPI-inflation will remain sticky at high levels for the foreseeable future and that (most) developed central banks will have little choice but to start to or further tighten monetary policy in the near future.

Figure 3: …with New Zealand, which has already hiked its policy rates, leading the way



Source: 4X Global Research, investing.com

Specifically markets are now pricing in that:

- There is a 90% probability of the **RBNZ** hiking its policy rate a further 25bp (to 0.75%) at its 24th November policy meeting.
- The **Norges Bank** will hike its policy rate 25bp (to 0.50%) at its December meeting, in line with the central bank's forward guidance of quarterly rate hikes.
- The **Bank of Canada** will start hiking its policy rate, which was left unchanged last week at 0.25%, as early as January 2022 and by a total of five 25bp hikes next year.
- The **Bank of England** will hike its policy rate by 15bp to 0.25% at its meeting on 4th November and hike rates by a further 75bp next year to about 1.00%. Governor Bailey, who has stressed the need to prevent high inflation from becoming permanently embedded, has so far done nothing to quell these market expectations.

- The **Reserve Bank of Australia** (RBA) will start hiking its policy rate (currently 0.10%) as early as March-April 2022.

Analysts' consensus view, which we share, is also that the **Federal Reserve** will at its policy meeting on 3rd November announce that it will start tapering its QE program (see Powell Put in play but greater challenges ahead, 1st September 2021). However, there is still some debate as to the exact timing and modalities of the Federal Reserve's tapering of monthly purchases of Treasuries and agency mortgage-backed securities currently running at respectively $80bn and $40bn.

Similarly analysts expect the **European Central Bank** to announce a tapering of its asset purchases as its 16th December policy meeting.

Finally, according to our calculations the **Bank of England** remains on track to complete its purchases of Gilts by year-end, as planned (its current holdings amounted to £849.7bn on 27th October and based on weekly purchases of about £3.4bn the Bank of England will hit its target of £875bn in the second half of December).

Rising government bond yields and monetary policy tightening: a prophet's dilemma?

Analysts are however less hawkish than markets, in particular with respect to the RBA, Bank of Canada and Bank of England. The consensus view is that the first RBA rate hike may not materialise before late-2022 or even 2023, due in part to the sharp fall in Australian CPI-inflation in Q3 to 3.0% yoy from 3.8% yoy in Q2 and headwinds to economic growth from domestic lockdowns and social distancing restrictions still in place. Analysts are also divided as to whether a majority of the nine Monetary Policy Council members of the Bank of England will on Thursday vote in favour of hiking the policy rate from its record-low of 0.10%. In any case analysts are of the view, which we share, that it will hike rates by far less than 85bp between now and end-2022.

Overall, we think hawkish interest rate markets may have got slightly ahead of themselves. The surge in short-end government bond yields in most developed economies since early October has de-facto resulted in a tightening of monetary conditions. For example most banks and mortgage providers in the United Kingdom have already increased their mortgage rates without the bank of England having lifted a finger.

Effectively, markets have already done some of the central banks' "dirty work". The rise in short-end government bond yields reduces the odds of central banks hiking rates as aggressively as currently priced in by markets, in our view – a self-defeating prophecy (or prophet's dilemma), at least partly. We indeed think that in coming months some developed central banks could conceivably try to cool market expectations of rate hikes and more broadly monetary policy tightening in order to cap short-end government yields and avoid a rapid tightening of monetary conditions weighing on economic growth.

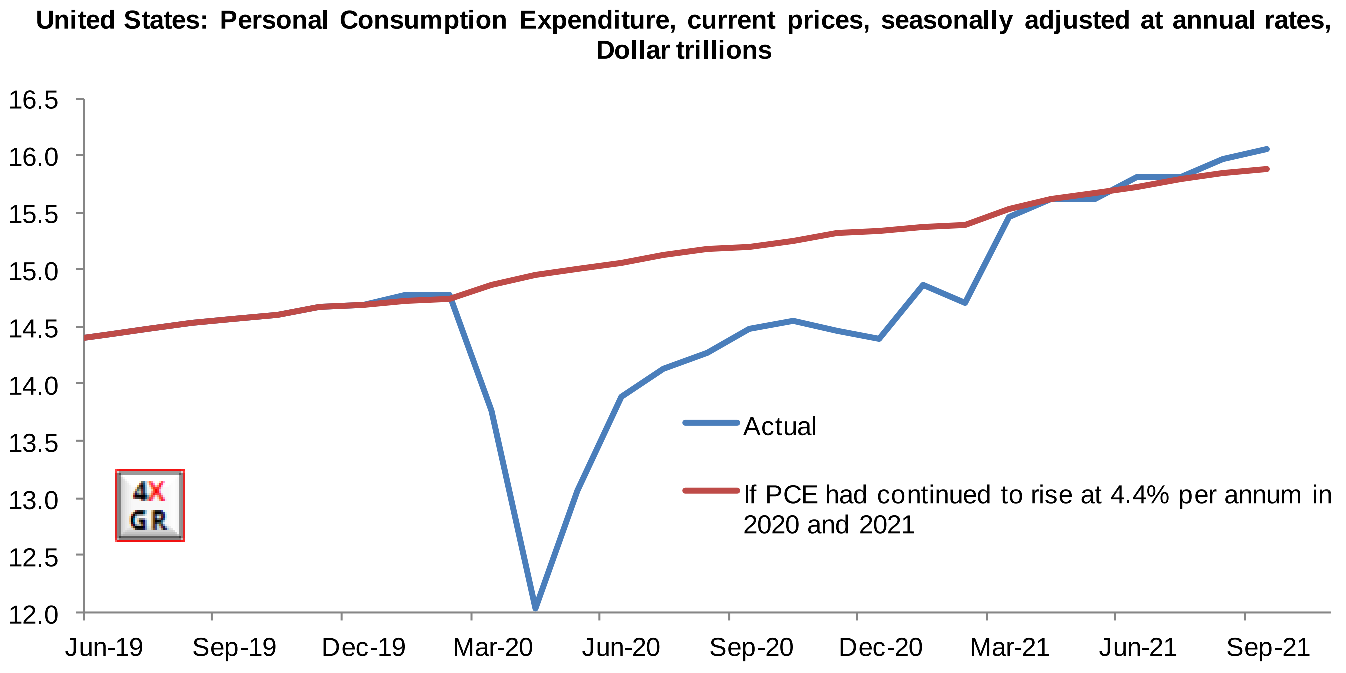
Federal Reserve – tapering one thing, hiking rates may well require stronger consumption

We certainly expect the Federal Reserve at its policy meeting tomorrow to once again, as it did at its 22nd September policy meeting, put some distance between the start of the QE taper and the start of the policy rate hiking cycle. Chairperson Powell in his pre-prepared press conference statement emphasised that *"The timing and pace of the coming reduction in asset purchases will not be intended to carry a direct signal regarding the timing of interest rate liftoff, for which we have articulated a different and substantially more stringent test*". Moreover, the updated "dot-chart" showed that half of the 18 FOMC members thought it would be appropriate to hike the policy rate by 25bp in 2022 but beyond 2022 FOMC members remained still very divided as to how high the policy rate should go.

Our reasoning is that while US household consumption is running slightly above its long-term trend it has in no way made up for the "loss" of consumption in the 12 months to March 2021. Moreover, slower household consumption growth in recent months (albeit from a high level) has led to weaker demand-pull inflation and contributed to the fall in month-on-month PCE-inflation, in our view.

Personal Consumption Expenditure (PCE) at current prices rose on average by 4.4% per annum in 2018-2019. The red line in Figure 4 depicts PCE had it continued to rise at this annual rate in 2020-21. According to our estimates actual PCE (blue line) returned to trend in April 2021 and in June-September 2021 was actually slightly above trend. However, cumulative PCE between January 2020 and September 2021 was still about $1.1 trn (or 4.1%) lower than if PCE had continued to increase at 4.4% per annum.

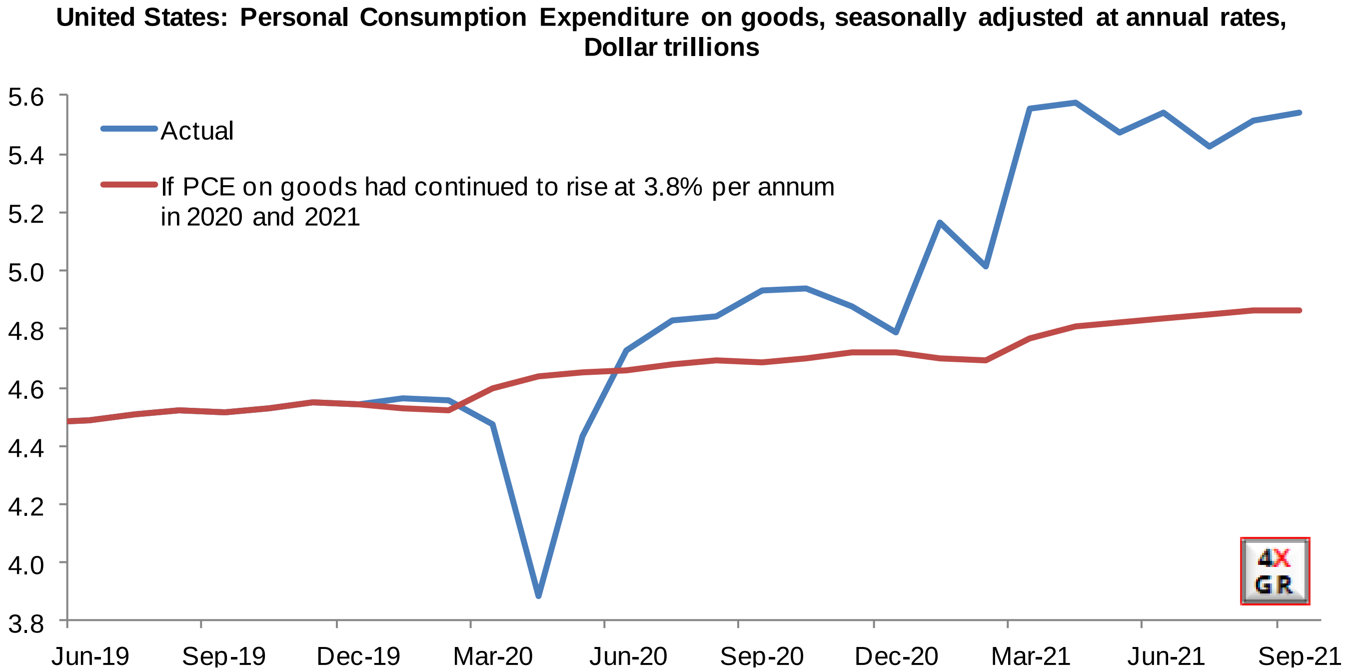
Figure 4: US household consumption back on trend but still a $1.1 trn "pandemic shortfall"



Source: 4X Global Research, US Bureau of Economic Analysis

The reason for this significant PCE "pandemic shortfall" – equivalent to the annual GDP of the Netherlands – is that while PCE on goods (which can be proxied by retail sales) has surged well above trend, PCE on services (which in the US has historically been more than twice as large as PCE on goods) has remained very weak. Specifically, cumulative PCE on goods between January 2020 and September 2021 was about $0.5 trn (or 5.7%) higher than if PCE on goods had continued to increase at 3.8% per annum (its average annual growth rate in 2018-2019) – see Figure 5.

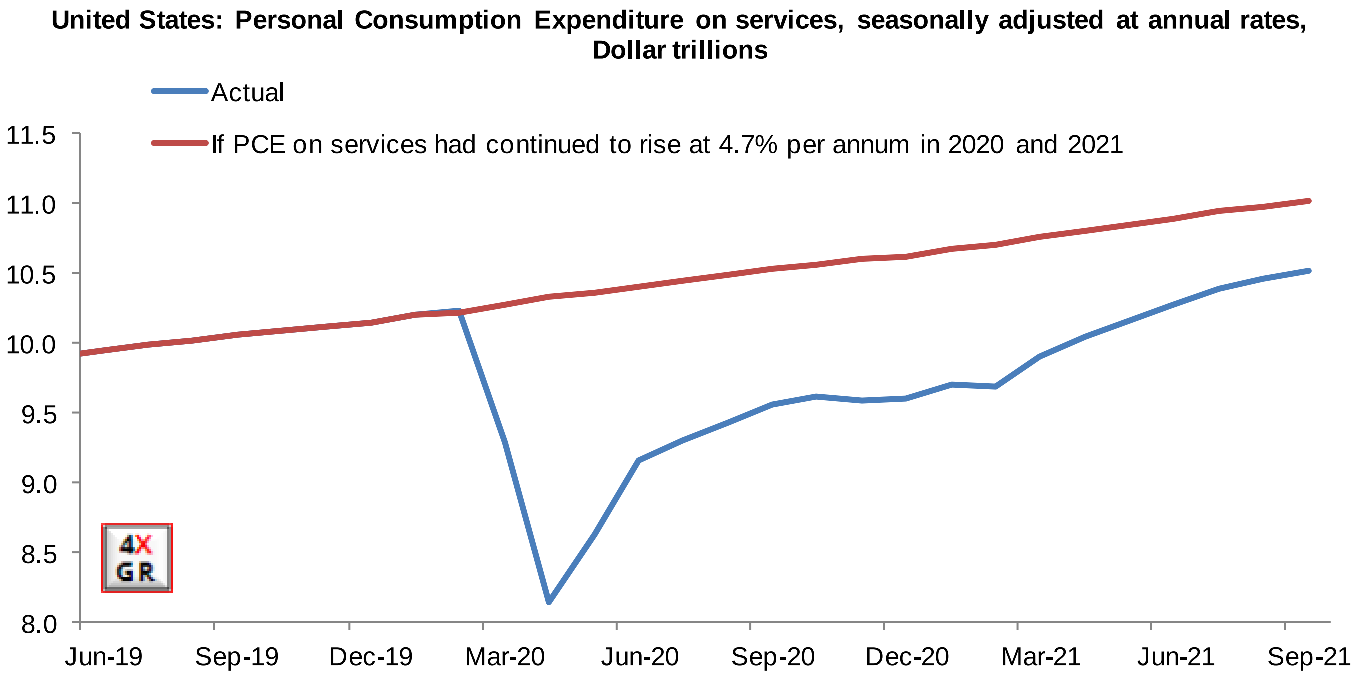
Figure 5: US consumption of goods has sky-rocketed…



Source: 4X Global Research, US Bureau of Economic Analysis

Conversely, cumulative PCE on services between January 2020 and September 2021 was about $1.6 trn (or 8.4%) lower than if PCE on services had continued to increase at 4.7% per annum (its average annual growth rate in 2018-2019) – see Figure 6. There a number of reasons for this stark discrepancy between spending on goods and services. First, social distancing restrictions have until recently deprived or limited consumer access to many services (which, unlike most goods, cannot be purchased on-line). Second, US consumers postponed some of their goods purchases but this has been harder to do for services (after all there are only so many meals, movies or holidays the average household can consume at any one time).

Figure 6: ….but US consumption of services still well below historical trend



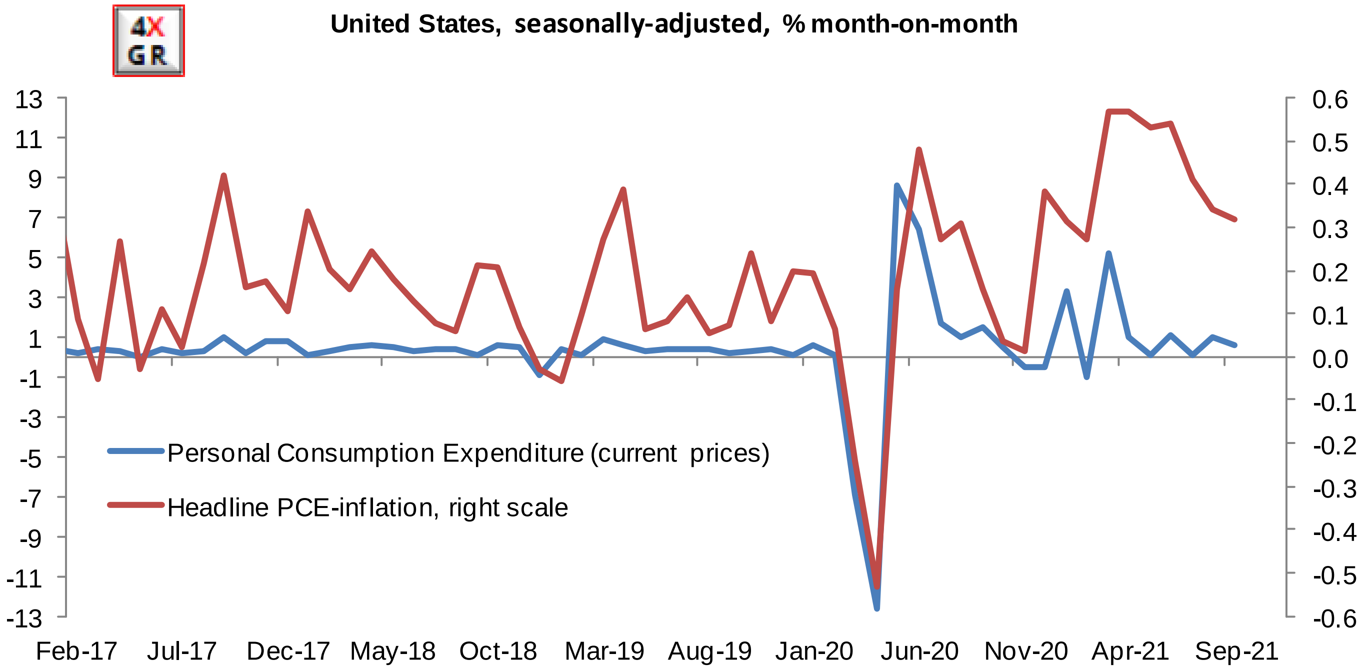
Source: 4X Global Research, US Bureau of Economic Analysis

In any case we think the Federal Reserve will be comfortable letting household consumption (and by extension the economy) run a little hot for a while in order to at least partly make up for the collapse in demand last year. Moreover, while in level terms PCE is back on trend, its monthly rate of growth slowed in Q3, averaging only 0.5% mom according to our calculations (see Figure 7).

We would argue that this has helped temper the month-on-month rate of PCE-inflation. Nevertheless, the still material gap between the rates of PCE and PCE-inflation suggests to us that supply-push inflation (including high commodity and energy prices) – over which the Federal Reserve has arguably limited influence – rather than demand-pull inflation (i.e. consumption) – over which the Federal has greater influence – is still the major factor driving high PCE-inflation rates. Irrespective of developments in international commodity and energy prices medium-term, we think the Federal Reserve will want greater evidence that PCE is on a strong footing before looking to hike its policy rate.

Forecasting PCE growth is complex as it is driven by a significant number of inter-related and often self-reinforcing factors. Yet our detailed analysis shows a strong, positive historical correlation between disposable income (including wages & salaries), US consumer confidence, households' net-worth (including equity holdings), and PCE (see The key quartet: US income, confidence, net worth and consumption, 18th October 2019).

Figure 7: PCE-inflation has slowed in recent months, in line with weaker PCE growth



Source: 4X Global Research, US Bureau of Economic Analysis

The rally in the S&P 500 to a record high and fall in the US savings rate back to its pre-pandemic ratio of about 7.5% of disposable income bode well for PCE near-term, in our view. However, disposable income (in current prices) was flat in August and contracted 1.3% mom in September. Moreover, the Conference Board consumer confidence index fell sharply in August and again in September to a 7-month low of 109.8 and despite rebounding in October to 113.8 remains well below its average level in June-July of 127.

US household consumption remains robust both in absolute terms and relative to household consumption in other major economies, including the Eurozone and United Kingdom, but not all the elements are currently in place for US PCE to take another leg up, in our view – a theme we will explore in forthcoming *FIRMS* reports.

DISCLAIMER & DISCLOSURE STATEMENT