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R&R Weekly Column
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The Risk of Inflation Could Spoil The Second "Roaring Twenties"

The recent rise in Eurozone inflation, from -0.3 y/y to +0.9% y/y in January 2021, has sent some shivers down investors' backs, especially considering that inflation has also risen from +0.2% y/y in May 2020 to 1.4% y/y in January 2021 in the US. Mostly it is technical factors that are behind this rapid increase in inflation numbers: base effects kicking in after one year of pandemic, the recent rise in oil prices (partly driven by the economic rebound after the slump in economic activity experienced in 2020), the recalibration of the basket of goods and services being used to calculate inflation gauges, and in the case of Germany and the Eurozone the fading of the deflationary effect of the 2020 VAT cut that was taken to counter the worst effects of the pandemic.

In spite of the recent increases, inflation remains definitely under control, well below the central banks' targets, which are usually set around 2% in most developed markets. In the short term, some potential increases may derive from supply bottlenecks due to the disruption of global supply and value chains, which can reduce the availability of goods and services. The pandemic has shown that although these supply and value chains were very long and efficient during the merry years of globalisation, they are also very fragile. So, the main reasons behind a potential increase in inflation in the short run may be technical factors and supply shortages. To observe a more persistent rise in inflation we would need to wait for the closure of the largely negative output gaps that exist around the world, when economic activity returns towards potential and unemployment rates approach the non-accelerating inflation rate of unemployment (NAIRU). We do not expect this normalisation in economic activity to occur before H2 2021 at the earliest, with 2022 and 2023 more likely candidates.

Even then, the "new normal" in economic activity may be very different from the era that preceded it. Jobs will be even more precarious than they were pre-crisis; the gig economy may become the new paradigm for an entire generation; the bargaining power of unions will be virtually zero for years to come. Hence, the possibility of strong, persistent, domestically-generated inflation will be limited in any case.

Considering this, how will central banks react? The vast majority of central banks in both DMs and EMs will likely look past temporary inflation spikes, especially if they are easily explained by technical factors. They can certainly tolerate transient increases in inflation due to short-term shortages of supply, so long as the output gap remains largely negative. They may be less tolerant towards a rise in inflation if the output gap is closing (even if that inflation is generated by technical factors or supply shocks), as a closing output gap may feed into inflation expectations. They will definitely be very vigilant against domestically-generated, demand-driven inflation deriving from the closure of the output gap and from unemployment rates reaching the NAIRU.

Even in those circumstances, however, the reaction of central banks is likely to be moderate, at least to begin with. The adoption of formal or informal versions of Average Inflation Targeting (AIT) regimes will dictate that banks keep their monetary policy stance looser than they otherwise would, so as to recoup some of the price level lost during the years of inflation overshooting target levels. In any case, inflation is the variable to watch in coming years, given the impacts it could have on asset prices. A rapid rise in inflation will likely dent the valuation of all major asset classes, and will certainly hurt bonds (both sovereign and corporate), and most likely equities as well (via their dividend discount models of valuation) if central banks are expected to normalise their policy stances sooner than they otherwise would. Even assets that are traditionally considered to be inflation hedges, such as gold, may need to prove their resilience in the event of rising inflation. Certainly crypto-assets will have to prove that they really are a good inflation hedge, even if these days they are highly sought after given mounting inflation concerns. Indeed, inflation may be the one variable that could transform the expected "roaring twenties" into the "moaning twenties" – if investors are disappointed by asset prices.

Our Recent Publications

- Flash Review: The Riksbank Remains Firmly On Hold, With A Dovish Twist, *by Brunello Rosa and Fawaz Sulaiman Al Mughrabi, 10 February 2021*
- **GEOPOLITICAL CORNER:** Armin Laschet and the Reality of European Neutralism, *by John C. Hulsman, 9 February 2021*

Looking Ahead

The Week Ahead: US And EZ PMIs Along With Japan GDP Estimates Are Expected To Decline

In the US, February's PMI data for: *i)* manufacturing are expected to slow to 58.5 (*p*: 59.2); and *ii)* services to fall to 57.5 (*p:* 58.3).

In the EZ: *i)* manufacturing PMI is expected to stay subdued at 54.4 (*p:* 54.8); while *ii)* services are likely to increase to 46.0 (*p:* 45.4).

In Japan, preliminary 'Q4 2020 GDP estimates' are expected to show a decline to 2.3% q-o-q (*p:* 5.3%) - and to 9.5% (*p:* 22.9%) on an annualized basis.

The Quarter Ahead: COVID-19 vaccine reaches 77 countries; US stimulus talks advance; political uncertainties remain elevated

Globally, governments and central banks are likely to keep policy-support in place, as the costs associated with premature tightening outweigh those associated with leaving support in place. Across 77 countries, more than 168m vaccines have been administered– roughly 5.84m doses a day.

US Fed Chair Powell highlighted the importance of maintaining a *"patiently accommodative monetary policy stance"* to boost the labor market recovery amid the ongoing COVID-19 pandemic – hinting towards a longer period of low interest rates.

In the US, more Americans have now 'received at least one dose' than have 'tested positive for the virus' since the pandemic began. So far, 50.1m doses have been given, according to a state-by-state tally. In addition, the US reported a 25% drop in new COVID-19 cases, to about 825k - the biggest fall since the pandemic started.

House Democrats put forward their proposed 'Coronavirus relief bill', that includes: *i)* USD 1.4k direct payments; *ii)* an extension of unemployment programs; and *iii)* payments to families with children. Democrats still need to overcome hurdles to get the legislation through the Senate – as budget reconciliation rules and skepticism about some provisions pose challenges.

The US Senate voted to acquit former President Donald Trump on the charge: *'inciting an insurrection at the Capitol'* - with a 57-43 tally, falling short of the 67 needed to convict.

In the EZ, Mr. Draghi, the ex-head of the ECB, has named his cabinet after: *i)* meeting the Italian president; and *ii)* securing the support of almost all the main political parties, following the collapse of the previous administration. Mr. Draghi is charged with managing both the COVID-19 pandemic and the economic recovery.

Last Week's Review

Real Economy: US Labor Market In Slow Recovery, As Inflation Remains Below Target

In the US, in the week ended on February 6, the number of 'filings for unemployment benefits' fell to 793k (*c:* 793k; *p:* 812k), the lowest level in four weeks - but still high, as a lack of fiscal support hampers the 'labor market recovery'.

Still in the US, in January: *i)* CPI remained unchanged, below expectations at 1.4% y-o-y (*c:* 1.5%; *p:* 1.4%); while core-CPI inflation fell more-than-expected to 1.4% (*c:* 1.5%; *p:* 1.6%).

In Sweden, during its February meeting the Riksbank held its benchmark interest rate at 0.0%, and policymakers noted "*it will take until 2023 before inflation is permanently close to the target of 2.0%*".

In Mexico, the CB Banxico cut its key policy rate by 25bps to 4.00% (*c:* 4.00%; *p:* 4.25%), resuming an easing cycle.

In Russia, the Bank of Russia held its key interest rate at 4.25% (*c:* 4.25%; *p:* 4.25%), noting that "*inflation expectations of households and businesses remained elevated*".

Financial Markets: Equity Rally Continues, Bonds Flat; Commodities Gain As USD Weakens

Market drivers: most indexes showed a second week of gains and reached record highs, supported by: *i)* the accelerating rollout of coronavirus vaccines; and *ii)* declining infection trends.

Global equities closed higher w-o-w (MSCI ACWI, +1.7%, to 682). In the *US*, the S&P 500 Index rose (+1.2%, to 3,935), boosted by: *i)* communication services stocks outperformance; and *ii)* solid gains in Twitter and video gaming shares. In the *EZ*, European equity markets were volatile but ended generally higher (Eurostoxx 50, +1.1%, to 3,696), driven by: *i)* improving COVID-19 infection rates; *ii)* the rollout of vaccination campaigns; and *iii)* hopes of a large US economic stimulus.

Fixed Income: w-o-w global bonds remained flat (BAML Global, -0.1% to 296.4), while USTs rose (+3 bps, to 1.20%).

FX: w-o-w, the USD traded lower against other currencies (DXY, -0.6%, to 90.480; EUR/USD +0.6%, to 1.212).

Commodities: Oil prices rose (Brent, +5.2% to 62.4 USD/b) as: *i)* OPEC+ continues its output containment policy and *ii)* crude stockpiles are at the lowest in nearly a year. Gold rose (+0.7% to 1,823 USD/Oz.), due to a weaker USD, and hopes of more US stimulus.

Farah Aladsani *contributed to this Viewsletter.*

The picture in the front page comes from this website

Abbreviations, Acronyms and Definitions

a	*Actual*	*LN*	*Northern League, Italy*
AKP	*Justice and Development Party, Turkey*	*M5S*	*Five Star Movement, Italy*
ann.	*annualized*	*m-o-m*	*Month-on-month*
ARS	*Argentinian Peso*	*mb*	*Million barrels*
avg.	*Average*	*mb/d*	*Million barrels per day*
bn	*Billion*	*MENA*	*Middle East and North Africa*
BoC	*Bank of Canada*	*MHP*	*Nationalist Movement Party, Turkey*
BoE	*Bank of England*	*mn*	*Million*
BoJ	*Bank of Japan*	*MPC*	*Monetary Policy Committee*
bpd	*Barrels per day*	*NAFTA*	*North-American Free Trade Agreement*
bps	*Basis points*	*NATO*	*North Atlantic Treaty Organization*
BS	*Balance sheet*	*OECD*	*Organization for Economic Cooperation and Development*
c	*Consensus*	*Opec*	*Organization of Petroleum Exporting Countries*
C/A	*Current account*	*p*	*Previous*
CB	*Central bank*	*P2P*	*Peer-to-peer*
CBB	*Central Bank of Bahrain*	*PBoC*	*People's Bank of China*
CBK	*Central Bank of Kuwait*	*PCE*	*Personal Consumption Expenditures*
CBT	*Central Bank of Turkey*	*PE*	*Price to earnings ratio*
CDU	*Christian Democratic Union, Germany*	*PM*	*Prime minister*
CNY	*Chinese Yuan*	*PMI*	*Purchasing managers' index*
CPI	*Consumer Price Index*	*pps*	*Percentage points*
DJIA	*Dow Jones Industrial Average Index*	*pw*	*Previous week*
DJEM	*Dow Jones Emerging Markets Index*	*QCB*	*Qatar Central Bank*
d-o-d	*Day-on-day*	*QAR*	*Qatari Riyal*
DXY	*US Dollar Index*	*QE*	*Quantitative easing*
EC	*European Commission*	*q-o-q*	*Quarter-on-quarter*
ECB	*European Central Bank*	*RE*	*Real estate*
ECJ	*European Court of Justice*	*RBA*	*Reserve Bank of Australia*
EIA	*US Energy Information Agency*	*RRR*	*Reserve Requirement Ratio*
EM	*Emerging Markets*	*RUB*	*Russian Rouble*
EP	*European Parliament*	*SWF*	*Sovereign Wealth Fund*
EPS	*Earnings per share*	*tn*	*Trillion*
EU	*European Union*	*TRY*	*Turkish Lira*
EUR	*Euro*	*UAE*	*United Arab Emirates*
EZ	*Eurozone*	*UK*	*United Kingdom*
Fed	*US Federal Reserve*	*US*	*United States*
FOMC	*US Federal Open Market Committee*	*USD*	*United States Dollar*
FRB	*US Federal Reserve Board*	*USD/b*	*USD per barrel*
FX	*Foreign exchange*	*UST*	*US Treasury bills/bonds*
FY	*Fiscal Year*	*VAT*	*Value added tax*
GCC	*Gulf Cooperation Council*	*VIX*	*Chicago Board Options Exchange Volatility Index*
GBP	*British pound*	*WTI*	*West Texas Intermediate*
GDP	*Gross domestic product*	*WTO*	*World Trade Organisation*
IMF	*International Monetary Fund*	*w*	*Week*
INR	*Indian Rupee*	*w-o-w*	*Week-on-week*
IPO	*Initial public offering*	*y*	*Year*
IRR	*Iranian Rial*	*y-o-y*	*Year-on-year*
JPY	*Japanese yen*	*y-t-d*	*Year-to-date*
k	thousand	*ZAR*	*South African Rand*
KSA	*Kingdom of Saudi Arabia*	*2y; 10y*	*2-year; 10-year*