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R&R Weekly Column
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Inflation Scares Market Participants, But Shouldn't Be Such a Worry (In The Short Run)

Last week, US inflation data for April came in much higher than expected. For headline figures, the month-on-month (m-o-m) inflation rate increased by 0.8% in April, versus an expectation of a 0.2% rise, up from the 0.6% rise registered in March. The year-on-year (y-o-y) inflation rate in the US rose to 4.2% in April, up from 2.6% in March and well above market expectations of a 3.6% increase. In terms of core inflation, the monthly increase was 0.9%, versus the 0.3% expected and recorded in March. The yearly increase was 3%, versus the expected 2.3%, a notable acceleration from the 1.6% recorded in March.

Market participants got spooked, as the m-o-m increase in headline inflation was the highest jump since 2009, the y-o-y increase in headline inflation was the highest reading since September 2008, the m-o-m increase in core inflation was the largest jump since 1996 and the 3% y-o-y reading in core inflation was the highest since the mid-1990s. Is this fear justified?

The surge in inflation is due to the re-opening of the economy, which led to an increase in commodity prices, the emergence of bottlenecks in global supply chains (such as for semi-conductors and computer chips), and base effects, considering that in April 2020 the y-o-y inflation rate collapsed to 0.3% and oil prices became negative for the first time in their history. In fact, the biggest increases were recorded for gasoline (49.6% vs 22.5% in March), fuel oil (37.3% vs 20.2%) and used cars and trucks (21% vs 9.4%). Inflation slowed for medical care services (2.2% vs 2.7% in March) and food (2.4% vs 3.5%).

So, it seems that inflation will exhibit, in the US, some high inflation readings for the next few months, until the situation stabilises, in terms of supply, demand, commodity prices and base effects. Should we worry about a persistent rise in inflation? For that to happen, we should observe a rapid increase in wages, following a closure of the output gap and the economy reaching full employment. It does not seem we are there yet. In April, non-farm payroll rose by "only" 266K, versus the 1 million expected (one of the largest misses ever recorded), a marked deceleration from the 770K record in March (downwardly revised from 916K). The unemployment rate, instead of decreasing further to 5.8% as expected, instead rose from 6.1% from 6.0%, perhaps as a result of the increase in the labour force participation rate, to 61.7% from 61.5%. Crucially, the yearly increase in average weekly earning fell from 4.2% to 0.3%.

Now, it is possible that inflation will accelerate further as the output gap closes, as discussed in our recent analysis on US inflation. But we do not think inflation will start haunting us just yet. And even if it does, central banks will be cautious in withdrawing monetary accommodation as long as the pandemic lasts and economic activity needs to recover previous losses. In this respect, the Fed – even recently - was adamant in excluding the possibility that it will react to rises in inflation that are considered transient.

Market participants seem to get this point: early last week, equity prices suffered the steepest selloff since October, but recovered most losses on Thursday and Friday, as buyers rapidly stepped back into the market. In the week ending May 12, US stock funds drew the most inflows since March. In the *fixed income space*, Eurodollars futures prices don't fully price in a rate increase before 2023 at the earliest. As a result, the 2y yield is around 0.15% (in the middle of the 0-0.25% Fed funds target range). Further down the curve, the 10y US Treasury yield remains close to 1.60%, after the surge recorded from August 2020 (when it touched 0.5%) and March 2021 (when it surpassed 1.7%). In *the currency space*, the USD remain week versus the EUR (with EUR/USD at 1.21) and has weakened versus the CAD, NZD, and AUD recently. So it seems that the market is understanding the Fed's reaction function.

In the medium term, the situation may change, and as Nouriel Roubini recently wrote, the risk of a new era of stagflation over the coming decade is a real possibility.

Our Recent Publications

- The US and Iran Aim to Restore the JCPOA, but Obstacles Remain, *by Giorgio Cafiero, 12 May 2021*
- 2021-22 Oil Outlook: Prices To Recover, As Global Demand Improves, *by Alessandro Magnoli Bocchi and Fawaz Sulaiman Al Mughrabi, 5 May 2021*

Looking Ahead

The Week Ahead: US, EZ And Japanese Manufacturing PMI Expected To Remain Stable

In the US, in May: *i)* manufacturing PMI is likely to remain stable at 64.7 (*p*: 64.0); while *ii)* services' PMI is likely to decelerate slightly to 59.8 (*p:* 60.5).

In the EZ, in May: *i)* manufacturing PMI is expected to remain unchanged at 62.5 (*p:* 62.9); while *ii)* services are expected to increase to 52.0 (*p:* 50.5).

In Japan, in May: *i)* manufacturing PMI is likely to remain stable at 53.3 (*p*: 53.6); and *ii)* services PMI is likely to rise slightly to 50.0 (*p:* 49.5). GDP growth is expected to decline: *1)* in Q1-2021, to -1.2% q-o-q (*p:* 2.8%); and *2)* annualized, down to -4.6% (*p:* 11.7%). April's core-CPI inflation rate is expected to decline further to -0.2% y-o-y (*p:* -0.1%), while the inflation rate is expected to increase to 0.1% y-o-y (*p*: -0.2%).

The Quarter Ahead: US Moves Closer To Post-COVID-19 Reopening, Inflation Under Tight Scrutiny

Globally, over the next couple of years, if supply fails to keep pace with demand, core inflation is likely to remain elevated. However, a rebound in inflation is more likely in the US than in Europe or Japan, driven by the 'Biden fiscal stimulus'.

In the EZ, growth and inflation are likely to overshoot expectations.

In the US, teenager vaccination starts, while fully vaccinated individuals can stop wearing masks. Last week, the 'Center for Disease Control and Prevention' (CDC) authorized usage of Pfizer and BioNTech's Covid-19 vaccines for 12- to 15-year-olds. The US started the world's first mass teenager inoculation effort, and President Joe Biden described it as "*one more giant step in our fight against the pandemic*." In the meantime, the CDC announced that fully vaccinated Americans may stop wearing masks or maintaining social distance in most indoor and outdoor settings.

In the UK, fears continue to grow over virus mutations. UK Public Health data show that India's COVID-19 variant (B.1.617.2) makes up between 40% and half of all cases detected in London. Prime Minister Boris Johnson warned "*the country's lockdown easing plans may have to be delayed due to the emergence of the variant*" and a surge of infections.

Israel's conflict with the Palestinians intensified, as: *1)* bombardment of Gaza extended into a seventh day; *2)* across the occupied West Bank, mass protests intensified; and *3)* communal riots worsened in several cities. The Biden administration's envoy Hady Amr flew into Israel on Friday, with an aim "*to work toward a sustainable calm*".

Last Week's Review

Real Economy: COVID-19 Variants Pose Downside Risks To Global Activity. CBs On Hold

In the US, April retails sales increased by 51.20% y-o-y (*p:* 29%), the biggest annual increase on record, mostly due to low base effects from last year. Concomitantly, export prices rose by 14.4% y-o-y (*p:* 9.5%) and import prices increased by 10.6% (*p:* 7.0%). In April: *1)* core-CPI inflation rate rose by 3.0% (*p:* 1.6%), the largest annual increase since January 1996; and *2)* CPI inflation increased by 4.2% y-o-y (*p*: 2.6%), due to: *i)* a surge in demand, soaring commodity prices and supply constraints - as the economy reopens; and *ii)* a base effect (*April 2020 CPI:* 0.3%), as the coronavirus pandemic dented last year's economic activity.

In the EZ, March's IP surged by 10.9% y-o-y (-1.8%).

Financial Markets: Volatile Stocks End The Week With Losses; Bond Yields Rise; USD, Oil And Gold Rise

Market drivers**:** Global stocks experienced the worst week since February, as investors suffered: *1)* a 'US inflation scare'; and *2)* fears of tighter CB policy. After April data showed that consumer prices jumped to a 13-year high, stocks suffered the steepest selloff since October, but recovered most losses on Thursday and Friday, as buyers rapidly stepped back into the market: in the week ending May 12, US stock funds drew the most inflows since March.

Global equities: fell w-o-w (MSCI ACWI, -1.6%, to 699). In the *US*, the S&P 500 Index fell (-1.4%, to 4,174), starting the week with the worst three-day loss in nearly seven months. Investors fled the fast-growing (mostly tech) companies that many had favored over the past year. In the *EZ*, European stocks remained flat (Eurostoxx 50, -0.4%, to 4,017).

Fixed Income: w-o-w global bonds fell slightly (BAML Global, -0.4% to 291.4) and UST yields rose (+6 bps, to 1.64%) as investors sold USTs on inflation worries.

FX: w-o-w, the USD weakened (DXY, +0.1%, to 90.321; EUR/USD -0.2%, to 1.214), on concerns due to weakening growth and accelerating inflation.

Commodities: Oil prices rose (Brent, +0.6% to 68.7 USD/b), after a key US fuel pipeline reopened - after being shut down for days in response to a ransomware attack. Gold edged higher (+0.6% to 1,842 USD/Oz) on a USD pullback, though gains were curbed by fears of a sooner-than-expected rate hike, due to data showing a rise in US inflation.

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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*