MAKING SENSE OF *THIS* WORLD — *13 September 2021*

R&R Weekly Column
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Global Inflation And Stagflation, In The Short And Medium Term

In the last few months, the US and other advanced economies have witnessed their highest rates of inflation in decades. Headline inflation has reached 5% in the US and 3% in the Eurozone, while core inflation (which excludes energy and food prices) has also been on the rise, in some cases significantly so.

These inflation rates, unseen for many years, have spooked market participants. Inflation erodes the real value of investments in equities, bonds, and real estate. Yet if central banks were to increase their policy rates in order to stem the rising inflation (considering that price stability is often central banks' first, if not their only, mandate), higher market rates would ensue, and any valuation model based on discounted cash flows would therefore observe a rapid fall in valuation if the market yields that are used to discount future cash flows (either coupons for bonds, or dividends for equities) were to increase.

Most of these recent price increases have been linked to the reopening of the economy after the global shock experienced in 2020 due to the pandemic. The rise in energy prices due to the rebound in economic activity has resulted in an almost 1:1 increase in headline inflation. Base effects have played a large role as well. In Q2 2020, headline inflation collapsed (in part, as a result of tanking oil prices); one year later, not surprisingly, these effects have been reversed. The reopening of the economy in specific sectors that came to a sudden halt during the pandemic (car rentals, hospitality, travel, just to name a few) has meant selective increases in prices in those sectors, which are weighing on the overall inflation gauge.

Supply side bottlenecks are having a large impact as well. When the availability of crucial components in several global supply chains, such as semiconductors for the car industry, collapsed, prices of the scarcer goods increased. Finally, some specific one-off factors (such as the reversal of previous VAT cuts, such as those implemented in Germany to stimulate economic activity) have played a role in the recent increase in inflation rates observed globally.

For most central banks, these inflation spikes are temporary in nature, and will likely reverse themselves as soon as all these one-off factors wash out of the inflation calculations in coming months. However, some of them are starting to seek some insurance against the rising inflation ahead, by reducing the rate of monetary easing. This includes the ECB, which last week decided to buy EZ government bonds at a modestly lower pace in Q4 2021 compared to the first two quarters of the year.

While we tend to agree with the central banks' assessment, implying that market worries are probably exaggerated at this stage, we would also like to highlight the medium-term risks of structurally higher inflation. After the pandemic, and in particular considering the strained US-China relationships regarding the origin of the Covid-19 pandemic, global supply chains have been cut off and will likely be much shorter in coming years. Shorter supply chains are likely to be more robust and resilient, but are also conducive to higher prices. The disinflation experienced by the world as a result of China's entering the global economy during the 1990s has likely come to an end, and will likely reverse itself in coming years.

In addition, the unequal distribution of income, with progressively less going to the labour share and more to profits and rents since the 1970s, has reversed itself. This is perhaps also taking place as a result of the populist polices envisioned by many world leaders, including in the US. These also include an increase in minimum wages in a number of countries.

These factors – shorter and balkanized value chains, higher minimum wages, more income attributed to the remuneration of labour rather than capital – will likely imply structurally higher inflation rates in the medium term. They may also imply a more subdued growth environment, for example to repay the large amount of debt issued during the pandemic, in which case we would observe stagflation rather than simply inflation. This increased risk, and its seriousness, has been highlighted by Nouriel Roubini in a recent article.

Our Recent Publications

- Flash Review: The ECB Recalibrates PEPP by Moderately Reducing The Pace of Purchases, *by Brunello Rosa, 9 September 2021*
- ECB Flash Preview: Amid Higher Inflation, The Debate On QE Tapering Begins, *by Brunello Rosa and Fawaz Sulaiman Al Mughrabi, 3 September 2021*

Looking Ahead

The Week Ahead: Softer Inflation Rate Expected In The US; IP to Decelerate In The US And EZ; Machinery Orders To Fall In Japan

In the US, August IP is expected to decelerate to 5.0% y-o-y (p: 6.6%) while retails sales' decline is expected to ease to -0.1% (p: -1.1%).

In the EZ, July's IP is expected to decelerate to 6.0% y-o-y (p: 9.7%).

In Japan, July's machinery orders growth is expected to fall to 15.7% y-o-y (p: 18.6%).

In the US, in August, the inflation rate is expected to soften to 5.3% y-o-y (p: 5.4%), and 'core inflation' to 4.2% y-o-y (p: 4.3%).

The Quarter Ahead: COVID-19 Delta Weighs On Growth Outlook; Risks Remain Elevated; Cbs Remain Mute

In the US, the CDC says that unvaccinated people are 11 times more likely than vaccinated people to die from COVID-19. The study looked at COVID-19 cases, hospitalizations and deaths in 13 states and found "further evidence of the power of vaccination". More than 600k COVID-19 cases (from April through mid-July) were analyzed, and linked to vaccination status, as those who were unvaccinated were: *i)* about 4.5 times more likely to contract the virus; *ii)* more than 10 times more likely to be hospitalized; and *iii)* 11 times more likely to die from the disease.

EU Brexit chief rejects UK demands to rewrite Northern Ireland trade rules. The EU's top Brexit negotiator has flatly rejected UK demands to rewrite the rules governing trade between the British mainland and Northern Ireland, saying he was "prepared to be flexible and show goodwill but not to reopen five years of tortuous negotiations".

US and China held talks. US President Biden and Chinese President Xi Jinping held talks last week in an effort to ease hostilities between the two powers and reset lines of communication after recent high-level meetings were described by US officials as "unproductive". In the last seven months, the US has: *i)* accused China of human rights violations; *ii)* imposed sanctions; and *iii)* warned businesses about operating in Hong Kong.

The Fed's Beige Book showed "the US economy downshifted slightly" in August, and traders began pushing back prospects on when the Fed will reduce bond purchases.

Last Week's Review

Real Economy: Economic Activity Subdued By Lingering Risks, But Supported By DM Policies

In the EZ, in September, the 'Economic Sentiment Index' fell to 31.1 (p: 42.7).

In Germany, July's factory orders fell by 3.4% m-o-m (c: -1.0%; p:4.6%).

In Japan, final data for the GDP growth rate in Q2 recorded a 0.5% q-o-q (p: -1.1%).

In China, in August, exports increased by 25.6% y-o-y (c:17.1%; p: 19.3%) and imports by 33.1% y-o-y (c: 2p: 28.1%).

In their policy setting meetings, the ECB, BoC and RBA kept their interest rates unchanged at 0.0%, 0.25% and 0.1% respectively. Due to '*improved economic and financial conditions'*, ECB policy makers stated: 1) they would *'start conducting a moderately lower pace of net asset purchases under the PEPP for the rest of the year'*; and 2) *'the PEPP envelope would be maintained at EUR 1.85tn until at least the end of March 2022'* and, in any case, until the bank judges that the coronavirus crisis phase is over.

Financial Markets: Global Stocks Fall; Bond Yields Rise; A Stronger USD Weighs On Gold Prices.

Market drivers: investor sentiment weakened, as: *i)* investors grew concerned that surging COVID-19 cases could derail the economic recovery; *ii)* the latest US 'producer inflation' data rose more-than-expected, pressuring the Fed to step back easy monetary policies; while *iii)* a call between President Biden and President Xi Jinping raised hopes that tensions between US and China could be eased.

Global equities fell w-o-w (MSCI ACWI, -1.2%, to 737). In the US, the S&P 500 Index retreated (-1.3% w-o-w to 4,459), showing the biggest weekly declines since June, as: i*)* the small real estate sector led the declines, while *ii)* consumer staples and utilities stocks held up best. In the EZ, shares weakened (Eurostoxx 50, -0.8% to 4,170), amid: *i)* uncertainty about the economic outlook; *ii)* the continuing COVID-19 pandemic; and *iii)* subdued central bank policy. In EMs, equities fell (MSCI EMs, -0.5%, to 1,309), and Chinese stocks gained for a third straight week (Shanghai Comp., +3.4%, to 3,703). Volatility rose towards historical averages (VIX S&P 500, +4.6 points to 21.0, 52w avg.: 21.4; 10y avg.: 17.4).

Fixed Income: w-o-w global bonds were mute (BAML Global, -0.0% to 297.1) and UST yields rose (+2 bps, to 1.34%), as investors remain concerned over: i) slower growth; and ii) uncertainty about the timing of Fed tapering.

FX: w-o-w, the US Dollar Index rose slightly (DXY, +0.6%, to 92.582; EUR/USD -0.6%, to 1.181), the first weekly gain in three weeks. In EMs, currencies fell against the USD (MSCI EM Currency Index, -0.2% to 1,739).

Commodities: Oil prices rose (Brent, +0.4% to 72.9 USD/b), as investors are considering China's decision to tap - for the first time ever - its giant oil reserves, to ease the pressure of rising raw material prices. Gold prices weakened (-2.1% to 1,787 USD/Oz), the first weekly loss since early August amid strengthening USD.

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*