Has Powell Just Killed Inflation?

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Key points

- Market-based inflation expectations fell swiftly following Powell's hawkish speech – possibly even too much.
- We provide a summary of our 2022 economic outlook: we see 2022 as the year when the pandemic shock is finally absorbed, with consumer prices gently decelerating, although the inflation risk in the US is tangible.

We were surprised last week by Jay Powell's decision to take a "hawkish" approach to his testimonies to Congress by confirming the possibility to accelerate tapering – presumably to give the Federal Reserve (Fed) more space to hike rapidly next year – despite the emergence of the omicron variant. The market reaction has been swift, with expected 10-year ahead inflation falling back to or even slightly below the Fed's target. We suppose that the Fed is focusing on the fact that GDP is exceeding its potential level and that it could deal with a moderate exogenous shock without wiping out inflation risks, but if expected inflation were to fall even marginally lower, this would suggest the market is taking on board the possibility this might be a policy mistake. The contrast with the Bank of England was stark, since one of the most hawkish members of the Monetary Policy Committee – who had voted for a hike last month – talked about postponing the telegraphed tightening (again). The European Central Bank (ECB) acknowledged the increased uncertainty, but still looks intent to terminate Pandemic Emergency Purchase Programme (PEPP) in March 2022, with possibly some "two-stage" decision on Asset Purchase Program (APP). The variety of responses, beyond the differences in cyclical conditions facing the central banks, also reflects the lack of hard conclusion so far on the severity of the omicron variant.

Despite this new layer of uncertainty, we have published our "2022 outlook". Assuming omicron proves manageable, we think next year would be a year of absorption of the pandemic shock, after the compression of 2020 and the brutal decompression of the economy in 2021. We continue to think global pressure on supply should abate, which would allow a gradual deceleration in inflation without the need of sizeable policy tightening (the Fed would hike but market interest rates would remain negative in real terms). When it comes to risks around the baseline, we think there is a tendency now to read European developments with US lenses, although the situation across the Atlantic is very different. The possibility to see inflation turning persistent is tangible in the US, while we think it is a much lower risk in Europe where wages have not showed any sign of acceleration so far and labour participation has rebounded to its pre-pandemic level.

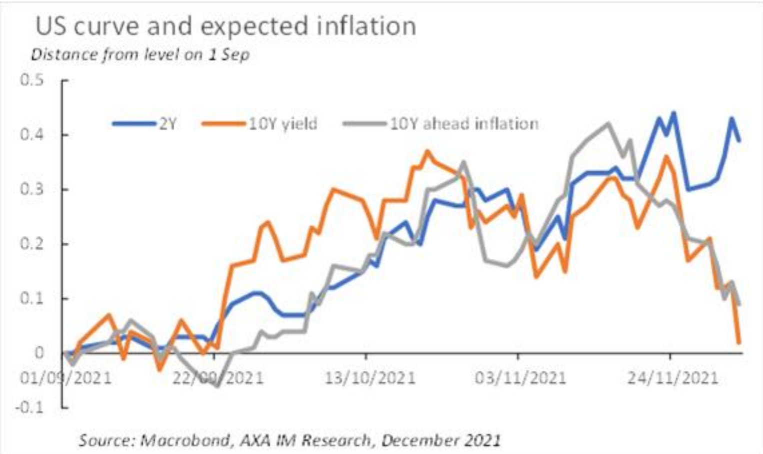
If US inflation were to turn persistent, we think the Fed would react and consumer prices would re-anchor quite swiftly. Even a central banker more focused on full employment than on inflation would see that not hiking more would trigger a toxic market-led tightening with a higher cost to economic growth. Admittedly, this could be addressed by engaging in "QE infinity" with yield control, but we don't think Jay Powell would countenance this.

Ambiguous optionality

We wrote last week that the Fed retained more optionality than the ECB, since it is not faced with an imminent policy announcement and retained wide flexibility around the timing of rate hikes and pace of tapering. We were however surprised that Jay Powell in his testimony to Congress chose to use this flexibility to send a hawkish message despite the additional uncertainty brought in by the omicron variant. He reiterated that the Fed could accelerate tapering so that the process would stop a "few months earlier", which of course would create space to hike more frequently next year. So far, the Fed had most of the time erred on the side of prudence when faced with potential impairments of the recovery. This apparent willingness to "brush off" another headwind would symmetrically signal more nervousness on inflation.

We continue to look at the shape of the US yield curve and the real/nominal breakdown of the long-term interest rates to assess the impact of the Fed's pronouncements. 2-year yields had retreated to 0.50% on 26 November in reaction to the omicron news but retraced it all back, reflecting the re-affirmation of the Fed's readiness to step up its normalization. Long-term yields however have not rebounded, crumbling to 1.33% on Friday, their lowest level since mid-September. The behaviour of consumer price-indexed bonds is quite telling: 10-year ahead inflation was priced at 2.43% last Friday, the lowest level since early October, down from a peak at 2.76% on 15 November. Given the usual wedge between Consumer Price Index (CPI) – the inflation measure for indexed bonds – and Personal Consumption Expenditures price index (PCE) – the Fed's favourite measure of consumer prices, this suggests that **the market is now expecting long-term inflation to be just at or even marginally below the Fed's target.**

Exhibit 1 – Has Powell just killed inflation?



Last week we argued that the curve flattening was testament to the Fed's credibility, in the sense that its (limited) pre-emptive strike was seen as enough to nip the inflation risks in the bud. However, given the market developments of the last few days, **even limited further flattening would signal the Fed would be seen as at risk of committing a policy mistake** by failing to provision for the budding omicron wave just weeks after being accused by some of being behind the curve (the symmetric risk). Of course, central banks are not expected to respond to every minute change in market conditions and market-based inflation expectations are notoriously fickle – they over-react to the most recent news-flow. Still, Jay Powell may be forced into some "fine-tuning" of his communication in the coming weeks.

True**, the Federal Open Market Committee (FOMC) can take comfort in the resilience of the data flow:** the strength in key surveys – such as the headline ISM services survey, which beat expectations and improved again in November – which probably offsets the mediocre print of the November payroll batch released last Friday. Yet, given the focus on the possibility of second-round inflation stemming from the labour market tightness we were surprised not to read more comments on the fact that hourly earnings – for once – grew less than expected in November. The year-on-year growth rate is still massive at 4.8%, but the monthly change (+0.26%) was not much higher than the pre-pandemic trend (0.21% per month between 2006 and December 2019). Again, we have warned our readers often enough against reading too much in a single month's worth of data, especially when it comes to the very volatile and heavily revised US Payroll numbers, but the message from the dataflow is becoming more subtle. The price component of the latest ISM survey, although remaining at elevated levels, has retreated in November. In US manufacturing, the backlog of orders in November has fallen to its lowest level since February 2021. We have been arguing for several weeks that "upstream" price pressure may have started to abate thanks to reduced pressure on global supply, and this may have started to materialize in the US business surveys, True, the improvement is very tentative and there is still ample scope for second round effects via the labour market, but **that the Fed seems ready to fully ignore those signals is surprising. We are tempted to ascribe this to the position in which the US economy is right now in terms of output gap**: the early 2021 fiscal stimulus has pushed the level of GDP above potential by mid-year. In this configuration, the US economy could cope with a moderate shock from the "omicron" without necessarily reducing that much underlying inflation pressure, in a context of extremely low interest rates.

Symmetrically, one of the most hawkish central banks of late, the Bank of England, seems to be having second thoughts ahead of the widely expected hike on 16 December. Michael Saunders is a normally hawkish member of the Monetary Policy Committee and voted in favour of a rate hike at the November meeting. Last Friday he opined that "*at present, given the new Omicron Covid variant has only been detected quite recently, there could be particular advantages in waiting to see more evidence on its possible effects on public health outcomes and hence on the economy*". He was careful to leave himself an exit route by stating that delaying the expected rate move for too long could entrench upward-drifting inflation expectations. Given the Bank of England's usual difficulty to steer a predictable course we would not want to over-interpret Saunders' statement, but there seems to be now a significant chance it will wait until next year, once the impact of omicron is properly assessed, before hiking.

The latest statements from the ECB leave us quite quizzical. In an interview to Reuters Christine Lagarde said that *"there are ways to give clarity without making long-term commitments and I would err on the side of not making (a) very long-term commitment because there is too much uncertainty".* Since in the same interview she confirmed her view that Pandemic Emergency Purchase Programme (PEPP) should be terminated in March, we would argue that it's precisely by not making long-term commitment on what would replace it (the expected recalibration of the Asset Purchase Programme, APP) that the ECB would add to uncertainty. The points we made on the ECB December forecasts being obsolete from day 1 is probably even more valid today with the further decline in oil prices.

Since its biggest quantitative programme explicitly refers to the "pandemic emergency", it is going to take some explaining to announce its termination while a potentially aggressive variant has emerged, and sanitary restrictions are being tightened across the Euro area. Our understanding is that even the doves don't feel they can keep on defending PEPP and the massive purchases given the rise in consumer prices for fear of a backlash in the most inflation-allergic member states. If PEPP is a "lost cause", then focus shifts to the recalibration of APP and potentially, the omicron uncertainty could convince a majority of the council to opt for a large upgrade, possibly initially for a short period (e.g. until June 2022) with a "rendez-vous clause by mid-year to reassess depending on the impact of the current Covid wave.

Reading in the tea leaves for 2022

We are bracing ourselves for quite a lot of market – and policy communication - volatility as we assess the severity of the omicron variant, as the market may focus on incomplete data together with alternating encouraging or concerning "soft" messages. This has already happened last week after the statement by the CEO of Moderna on the efficiency of the vaccines, followed by some rally after – very patchy – reports on the mildness of the disease in cases observed in South Africa.

It's true that the available data for now on the ground suggests that while the number of cases is growing much faster than in the previous waves, the number of hospitalizations and casualties does not seem to be higher. This would indeed be good news, but to our knowledge, **no large-scale study has been conducted so far providing clear indications on relative risks with or without vaccination among hospitalized patients**, possibly because the variant is relatively new. A source of complication is that the vaccination rate of the South African population is relatively low. The population is also very young (the median age is 26 years old), which makes finding a large enough sample of patients across the age groups of interest with a large enough proportion of vaccinated and unvaccinated individuals more difficult than in the West.

An important point to take into account as well is that irrespective of the severity of omicron, large parts of Europe are already re-instituting stricter sanitary rules, and the impact of pre-emptive anti-omicron measures on international travel ahead of the festive season is probably already significant. With the need to test before entering and (most of the time) leaving the European Union (EU), many potential travellers will probably re-think their plans, with a knock-on effect on tourism.

It seems to be a rule of macroeconomic forecasting that a significant source of uncertainty emerges between the elaboration of a year-ahead outlook and its publication. This is certainly the case for us with the omicron variant. We have however released our year-ahead outlook last week (see here for the full documents and links to videos), with the assumption that the variant wave would not trigger a prolonged, widespread return to massive sanitary restrictions. Anyway, even if this happened, we would not be back to square one, in the sense that modified vaccines would arrive relatively quickly. So, we would see the omicron variant as a source of *postponement* of the developments we described without necessarily changing its *sequence*.

Across the Atlantic, 2020 was a year of massive **compression** of economic activity. 2021 was a year of fast **decompression**, with demand catching up quickly as we were reopening, exerting significant pressure on supply, triggering a rise in consumer prices unseen in decades. Under the assumption omicron is manageable, we believe 2022 would be a year of gradual **absorption** of the pandemic shock, with robust but less spectacular GDP numbers, as much of the catch-up is now behind us, and a normalization of supply conditions allowing inflation to slow down.

While the US had been "leading the pack" on the recovery in the developed world, we see significant convergence in the GDP growth rates in 2022, with the Euro area even outpacing the US at 3.9% against 3.5%. Indeed, we have significantly revised down the US (from 4.5% in our September forecasts). This mostly reflects changes in the quantum of fiscal support in the US next year from our summer batch, as Joe Biden has been forced to significantly shrink the size of his intended programmes to overcome Congress opposition. However, the comparison of the growth rates is to some extent misleading. Since the US recovered earlier and initially faster than the Euro area, some slowdown was unavoidable anyway and its output gap was already plugged by mid-2021, while this would be achieved in the Euro area at the end of next year only (assuming potential growth unchanged at 1%).

Habitual readers of Macrocast will now that while lingering sanitary-related supply-side disruptions played a large role in the emergence of global bottlenecks, we think demand also played a major role. Everywhere, individuals shifted their consumption from services towards tradable goods, which often depend on long and tortuous international value chains. This has been particularly acute in the US. Assuming the pandemic no longer forces widespread compression in services activity, this phenomenon should be behind us by now, and is already reflected in the correction of some key international prices.

The capacity of this improvement in upstream inflationary pressure to dampen consumer prices will depend on the result of a "race" with second-round effects transiting via the labour market. **We think there is tendency now to read European developments with US lenses.** We think the two regions are profoundly different. A normalization of the US participation rate, from the currently stubbornly depressed level, easing the pressure on wages, is a key assumption in our baseline. Indeed, we think that a significant share of the persistent decline reflects lingering COVID-related issues – in particular around childcare. Yet, we accept perfectly that this may not happen, or too slowly, and that a persistent labour cost inflation could emerge in the US.

We think the risk is much lower in Europe, where the rebound in hiring difficulties is still to a large extent a return to structural flaws, most often skills mismatches, but contrary to the US no sign of wage acceleration can be observed. Labour participation in the Euro area has rebounded to its pre-pandemic level, contrary to the US (see Exhibit 2). In France it has reached its highest level since the mid-1970s (Exhibit 3). It is driven by the continuous rise in participation of older age groups – reflecting the successive pension reforms. This is a key difference with the US and the structure of pension in Europe – still dominated by defined benefits systems – makes it less likely that a strong performance in financial assets would trigger the emergence of a noticeable “young retirees” wave. But there is also a spectacular recovery in younger-age participation, accompanied by a decline of the number of “NEETs” (neither in education nor in employment). The rise in participation in the absence of an acceleration in wages would run against an inflationary scenario in Europe. Indeed, in the neo-classical model favoured by most hawks, individuals perform an arbitrage between leisure and work with the wage level as the key determinant.

Exhibit 2 – Not in Europe!

Exhibit 3 – Participation has never been that high in France

Given the balance of risks for inflation, the same distinction between the US and the Euro area should be made when it comes to monetary policy. Central banks are starting to phase down their stimulus, but while we have brought forward our expectation for the Fed lift-off to late 2022, with of course a significant chance it happens earlier (by the summer) we continue to think the ECB will resist the pressure and will wait until 2023 before hiking its policy rate. In our baseline, the PEPP would be terminated in March 2022 but partly offset by a recalibration of APP to EUR40bn per month until the end of 2022 “at least”. As we elaborated in the previous section, the current uncertainty may force the ECB to opt for a two-stage approach, with a large APP uptick in March which would be normalized to EUR 40bn by the summer, but the key issue for us is whether or not the ECB would still be in the market for *net* purchases of bonds at the end of 2022 (we think they will).

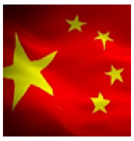
Even in the US though, economic policy would remain accommodative overall. Real interest rates would still be negative by year end. True, the new fiscal packages, especially in the US, are much smaller than in the last two years. But much of the past fiscal push has been “stored” in the form of excess savings by households, creating a welcome reserve of demand.

In the emerging world though, the credibility of central banks is not as strong and has forced them to engage in a significant monetary tightening, dampening demand. In some of the countries which are for now bucking the trend – such as Turkey, where the central bank is cutting rates – the fallout is massive in terms of currency depreciation. Emerging Markets will also be facing the headwind of less supportive Chinese demand, to which they are more sensitive than most advanced economies.

Indeed, China for once is not playing the role of a “global engine of growth”. Instead, as we have been discussing often in Macrocast, Beijing is trying to address years of excess in the real estate sector, and this will slow GDP growth, while its “zero case” Covid policy is potentially very costly to the recovery. While 5% is probably a “floor” to GDP growth – and we expect some policy loosening into 2022 – the world economy will have to deal with an unusually tepid Chinese demand.

The main risk to our scenario – beyond Covid of course – is that inflation gets more persistent than we think in the US, creating a situation where the Fed would be forced to hike much more quickly in 2022. If, contrary to the recent development, the market starts believing the tightening will have to go beyond the current Fed’s terminal rate (about 2.5% if one believes the dot plot), then long-term interest rates could rise into the 3% region (instead of 2/2.25% in our baseline) by the end of next year.

But we are often asked to consider a case where central banks find themselves reluctant to tighten, precisely for fear of “killing the recovery”, triggering an even larger rise in long-term interest rates through an increase in the inflation-protection premium. We don’t think this is a likely scenario, precisely because a central banker focused on full-employment would see that refusing to react would end up triggering an even more dangerous growth-busting market-led tightening. The only solution would then to engage in Quantitative Easing (QE) infinity with yield-control, in which the central bank would prevent the market from reacting. This would be quite extreme – and Powell does not strike us as someone who would preside over such a drift – and at least in Europe it would very quickly collide with the European Treaty.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• Fed Chair Powell said would “retire transitory” description of inflation and consider faster taper • The Senate passed a Stop-gap funding measure to avert a government shutdown until 18 Feb • Payrolls (Nov) surprised with just a 210k rise, but unemployment fell to 4.2% and participation edged higher to 61.8%. Earnings rose 0.3%mom • Cons confidence softened on inflation and COVID • Chicago PMI (Nov) dropped, but stayed solid, ISM (Nov) stable with some signs of easing constraints	• CPI inflation (Nov) forecast to rise to 6.7% (4.9% core). We expect closer to 7% by Dec. Also 5-10y inflation expect in U Mich survey • Weekly and U Mich measures (Dec) of consumer conf watched following recent dips • Labour turnover survey (JOLTS, Oct) watched for any signs of easing labour demand • Trade balance (Oct) expected to narrow • Non-farm products and unit labour costs (Q3)
	• Covid cases rise fast in Fr, stabilisation at high level in Ge, mandatory vaccination in Ge • EMU HICP Flash (Nov) rose to 4.9%yoy, above expect (4.5%), driven by stronger energy contrib and package holiday distortion in Ge • EC sentiment surveys unchanged vs Oct levels • Eurozone retail sales (Oct) rose by 0.2%mom	• Watching any information on Omicron strain and new hospitalisations that could trigger further restrictions • IP (Oct) growth could be slightly positive with auto sector mild rebound in Ge and Fr • Ge ZEW Economic sentiment (Dec) is expected to decline with covid restrictions
	• MPC comments ahead of Dec meeting add to fears Omicron could delay expected hike • House prices rose faster than expected 0.9%mom and 10%yoy despite income squeeze • Mfg PMI (Nov,F) at 58.1, economy sees solid momentum, despite high input prices • Migrant deaths add to tensions with France	• Coronavirus cases and hospitalisation, the impact of the Omicron variant • Monthly GDP (Oct) – 0.6% (cons) solid PMIs indicate buoyant growth • IP (Oct) 0.1% (cons) expect slight rebound after Sept contraction (-0.4%)
	• Services sector is standing better with PMI above 50 for the 2nd time (53.0) but consumer confi surprisingly flat at 39.2 • IP (Oct) rose by 1.1%mom / 1m and 2m expectations are up to 9% and 2.1%mom	• Reuters Tankan Mfg and Non-Mfg surveys (Dec) are expected to progress • Downward revisions on Q3 GDP growth are very likely especially on the capex front • Eco Watchers poll (Nov) and bus survey (Q4)
	• Fading impacts of power shortages lift manufacturing activity among large firms, although Caixin PMI, which captures smaller firms in export industry, dips below 50	• November trade surplus may decline as export growth comes off the boil. PPI and CPI gap should narrow, with PPI inflation easing on the back of weaker commodity prices
	• Hungary hiked +20bps to 3.10% • yoy GDP (Q3) slowed in Turkey (7.4%), Brazil (4.0%) and India (8.4%) • Export momentum moderating in Asia • Inflation (Nov) rose in Korea (3.7%), Indonesia (1.8%), Poland (7.7%) and Turkey (21.3%)	• CB: Brazil expected to hike +150bps to 9.25%, Poland +50bps to 1.75% and Peru +50bps to 2.50%. India could stay on hold (4.0%) • CPI (Nov) figures for Chile, Colombia, Hungary, Mexico, Philippines, Russia and Taiwan • IP (Oct) numbers for Hungary, India, Malaysia and Mexico

Upcoming events	US :	Tue: Trade (Oct), Non-farm productivity, ULC (Q3, r); Wed: JOLTS survey (Oct); Thu: Jobless claims (4 Dec), Fri: CPI inflation (Nov), Michigan consumer sentiment (Dec,p)
	Euro Area:	Mon: Eurogroup meeting, Ge new manufacturing orders (Oct); Tue: EU19 GDP (Q3), Ge Ind prod (Oct), Ge ZEW Survey (Dec); Thu: Ge Trade balance (Oct), Fri: EU19 & Ge HICP (Nov), It & Sp Ind prod (Oct)
	UK:	Mon: New car registrations (Nov), Construction PMI (Nov); Tue: BRC Retail Sales Monitor (Nov), Halifax house price index (Nov); Thu: RICS Housing Survey (Nov); Fri: Monthly GDP (Oct), Services index (Oct), Ind prod (Oct), Manufacturing & construction output (Oct), Trade balance (Oct),
	Japan:	Tue: Leading index (Oct,p), GDP (Q3), Trade balance (Oct), Current account (Oct), Exports & Imports (Nov), Forex reserves (Nov); Wed: Economy watchers survey (Nov)
	China:	Thu: CPI (Nov); Expected during the week: Total social financing (Nov), New yuan loans (Nov), M2 (Nov)

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