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Research & Strategy Insights

Forward-looking and short-sighted

83 – 15 March 2021

Key points

- Inflation expectations tend to be "over-sensitive" to the current message of business surveys, which have good predictive power over a short horizon only. Still, even if we think the looming acceleration in consumer prices in the US is transitory, its combination with dovish Fed statements will likely push inflation expectations further in the months ahead. The European Central Bank (ECB) will need to do more to resist contagion. They are already, but they are also making their policy framework more rigid. This will make for an interesting June meeting.

In the US, inflation expectations derived from market pricing continue to rise although observed core inflation has for the second month in a row surprised to the downside. Such disconnect is reassuring, suggesting that investors do not merely replicate the latest trend but behave in a forward-looking manner. Still, one can be forward-looking and short-sighted at the same time. Indeed, even 10-year inflation expectations are very sensitive to the current underlying state of the economy, proxied for instance by the price component of business surveys, which in the case of the ISM index was in February at its highest since 2008. These surveys can be pretty good at predicting inflation a few months ahead and we agree that consumer prices will accelerate into 2021, but it is premature to see in these indicators signals of a shift to a new inflation regime.

However, inflation expectations also take on board judgment calls on the policy stance. The Fed's pledge to tolerate inflation overshooting is an important shift. We think the Fed will maintain a dovish communication mode during the imminent acceleration in inflation, thus strengthening the credibility of their "Average Inflation Targeting" framework. This should push inflation expectations further up. We think it will be transitory, but it is one of the reasons why we continue to think that even at 1.6% – the level reached last Friday – 10-year yields in the US still have room to climb further.

The ECB pledged to accelerate its purchases in the quarter ahead, thus fighting contagion from the US. Still, the ECB added constraints onto itself. Indeed, they now consider that changing the pace of buying within the agreed envelope is part of the policy stance, which would entail a Governing Council meeting and preferably a new set of forecasts – only available once a quarter, next in June. This makes the ECB more reactive than preemptive. We expect a "discovery process" on the European bond market, conducive to volatility episodes.

Christine Lagarde mentioned the government support to business credit as an element of the "financing conditions" the ECB looks at. This brings us back to the financial position of corporates. The liquidity buffers they built last year are broadly intact, which suggests Europe has some time to deal with the long-term consequences of higher corporate debt. All the radical solutions on offer imply some fiscal cost. "Financial engineering" solutions may be preferable.

The proof may not be in this particular pudding

For the second month in a row, US core inflation came out below expectations (at 1.3% year-on-year in February), but US 10-year yields continued to push higher, reaching 1.63% at close last Friday, with another 4bp contribution from expected inflation over the week. This disconnect between the observed behaviour of consumer prices and market-based expectations is common (Exhibit 1) and reassuring. It suggests that **the market is not overly influenced by the very latest actual developments in price**s, themselves the lagged reflection of past macro conditions – a common feature of inflation surveys conducted with households – but is effectively forward-looking. The best example of this was the massive gap between stubborn, strong observed inflation in 2008 and collapsing expectations: the market was – fortunately – able to see through the transitory acceleration in consumer prices which was the legacy of pre-recession overheating, allowing market interest rates to fall, thus providing much welcome relief to the economy.

However, this does not mean investors are not collectively short-sighted. Indeed, they seem to react quite tightly to current cyclical indicators. In Exhibit 2 we compare the contemporary "price component" of the ISM non-manufacturing index (a business survey) to 10-year expected inflation derived from the treasury break evens. Some level shifts appear, for instance between 2011 and 2014 when market-expected inflation was "too high" relative to the message sent at the time on the state of price pressure by real economy businesses, but overall, when focusing on *chang*es, the relationship has been quite satisfactory.

Exhibit 1 – Market is forward-looking …

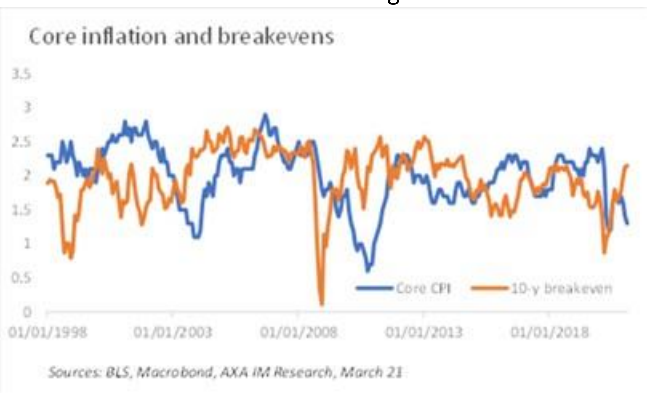


Exhibit 2 – …but not that much

The 2011-2014 disconnect is quite interesting in our view, since this coincided with the end of the US fiscal push triggered by the Great Financial Crisis of 2008-2009, "offset" by the continuation of a very accommodative monetary policy under Ben Bernanke at the Fed. During that phase, investors collectively ignored the message from the real economy – the mediocre growth rate of the time was not conducive to price hikes – to focus on what they thought would be the consequence of a persistently dovish central bank. In that instance, investors got it wrong. Inflation over the last 10 years has been lower than what expectations suggested back in 2011 (1.9% against 2.3%), but it took 3 years for the market to converge back to a more realistic level for the break-evens.

All this would get us to an ultra-simplistic "model" of expected inflation. The bedrock – or at least what is known with some measure of certainty at the time expectations are formed – is the current state of the economy, which can be proxied by surveys. To this we need to add what can be inferred from the policy stance, which will ultimately shape the future cyclical developments and hence the pressure of demand on supply. This second leg is by nature uncertain and depends on theoretical preconceptions. Things become particularly tricky when the two legs of economic policy don't push in the same direction, as was the case after the Great Financial Crisis. Even within the same conceptual framework, the net effect is not obvious to foresee (as illustrated by the forecasting error of the International Monetary Fund (IMF) at the beginning of the 2010s, which understated the recessive effect of fiscal austerity). To add another layer of doubt, the announced policy stance cannot be held for certain, especially towards the end of the forecasting horizon. The credibility of fiscal and monetary policy must be considered.

In our opinion, within this model the market is certainly right – in the US case – to lift inflation expectations, **since at the moment all of the factors are going in the same direction:** the ISM-price component in the services has hit in February 2021 its highest level since 2008, good news on the vaccination program continue to pile in, bringing forward the reopening of the economy, the Biden package is about to be implemented, and Jay Powell maintains the "inflation overshooting" mantra. **All the ingredients are there.**

Over the next six months, it is plausible that the market will see for itself that the Fed is seeing through a significant acceleration in inflation without altering its dovish communication stance, thus temporarily boosting the credibility of its Average Inflation Targeting framework. This may trigger another jump in expected inflation. To substantiate this, we go back to the price component of the ISM survey. Graphically, the linear relationship between this index and observed core inflation is poor. However, we look at all the episodes when this indicator stood more than 1.5 standard deviations above its long-term average (the current situation). Since the ISM index started being available outside the manufacturing sector in the late 1990s, we could identify five episodes of this nature in the US. In four cases, core inflation accelerated in the following months – in some cases significantly (Exhibit 3). The only time the ISM survey reported strong price pressure at the business level without an ensuing actual rise in core inflation was during the Great Financial Crisis, for obvious reasons. Still, the ISM index did not necessarily heralded lasting accelerations in consumer prices: in 2004 and 2006 the inflation flare-up was short-lived.

Exhibit 3 – Large deviations from mean of the ISM price component are good predictors of inflation accelerations over a short horizon

	Core CPI and non-manufacturing ISM index		
	3M average before z-score >1.5	3M average end of phase with z-score>1.5	3M average 6M after end of phase with z-score >1.5
May 04-Dec 04	1.5	2.3	2.1
Sep 05-Nov 05	2.1	2.1	2.6
Jul 06- Aug 06	2.6	2.8	2.5
Nov 07 -Sep 08	*2.1*	*2.0*	*1.8*
Feb 11 - May 11	0.8	1.6	2.2

Source: Bureau of Labor Statistics, ISM and AXA IM Research, March 2021

Still, at least for the coming months, the most plausible scenario is that inflation duly accelerates, while the Fed would continue expressing its benign view, repeating that it remains essential to maintain a very accommodative stance as the recovery is still too fragile. True, the Fed focuses on the change in core private consumption deflator (PCE) which is usually about 0.4% below the core CPI we look at here. Measured this way inflation may not exceed the Fed's target that much, based on the previous episodes, which would help Powell keep the mantra unchanged, but the market may not be won over by this distinction. In this central scenario, the market would be "right" to continue raising its long-term inflation expectations, because the Fed would in effect "walk the talk" and effectively let inflation build up without acting.

Inflation expectations are fickle, however, and this nice convergence of information streams, between real economy survey and messages from policymakers, may not last very long. The Biden push is short. Some of the measures are immediate, for instance the flagship "check" to households. While not all of it will be consumed immediately, it's a one off and the effect is likely to fade quite quickly. The federal top-up to the unemployment benefits ends in October. **The market will have to gauge the chances that Biden's investment plan swiftly follows the current emergency package to prolong the "overheating phase"** and politics don't look too promising on this front. Moreover, the failure to lift the minimum age offers some protection against risks of cost-push inflation magnifying the effect the demand push triggered by fiscal policy. The reduction of the federal top-up to USD300 may also help to avoid wage-boosting labour market bottlenecks – the initial USD400 might have incentivized some laid-off workers to defer their re-entry into employment.

This is why we think that, when it comes to inflation, we may have to wait until the very end of this year to see whether the Biden presidency heralds a "paradigm shift". As our habitual readers will know, we are sceptical, but in the meantime, we stick to our guns and consider that even after crossing the 1.5% limit, US 10-year yields can still climb further. We would not be surprised to see them hitting 2%, for instance on a combination of record payroll data, dovish statement by the Fed and a strong core inflation print. We see them receding to 1.75% by year end, but it's going to be a choppy ride.

ECB adding constraints onto itself

In Macrocast last week we sketched out our expectations for the ECB meeting: no "nuclear option" – depo rate cut, increase in the Pandemic Emergency Purchase Programme (PEPP) envelope – but an explicit mention in the "prepared statement" that the central bank would accelerate its purchases. Your humble servant confessed a moment of stress when, last Monday, the central bank reported another mediocre quantum of buying. We were reassured on Thursday with the ECB's decision – **the pledge to step up PEPP buying in the quarter ahead is unambiguous.** This is fully consistent with the affirmation of their inflation forecasts. True, they have acknowledged the stronger than expected rebound in January and February and pushed their projection for 2021, but crucially they haven't lifted their end of horizon well-below target 1.4% for 2023. Since even the monetary policy stance determined in December is unable to bring inflation back in line with the ECB's definition of price stability – quite an admission for a central bank – then any tightening from that point on would mechanically trigger a further deviation from target. Action is then needed.

This is what the market focused on immediately after the ECB announcement, and yields duly retreated. Although some retracement occurred later, our key metric now – the 10-year spread between the US and Germany – was wider on Friday close than before the ECB meeting (193 basis points against 183 on 10 March). Still, we are a bit concerned by some aspects of Christine Lagarde's communication last week. We will need to see exactly what the ECB practice in the coming weeks and months is, but potentially the central bank may have lost quite a lot of its agility.

Indeed, when asked why the central bank had not so far accelerated its quantum of purchases in response to the rise in market rates, the ECB President answered that "it seemed like a better idea" to wait for a Governing Council meeting, coinciding with a fresh batch of forecasts (they come every quarter), because (i) the issue at play here is the monetary stance – this would justify a full council meeting – and (ii) it's preferable to assess the financing conditions in view of the freshest possible macro outlook. Later, in the Q&A she reiterated this idea of a quarterly assessment. Since the power of the PEPP lies in its very flexibility, **it seems that the central bank is creating new constraints on itself. PEPP would become reactive, the central bank taking up to three months to assess financing conditions against its macro outlook.** This would put the ECB quite far from effective yield curve control.

True, Christine Lagarde mentioned some "escape clauses", in particular the possibility for the Governing Council to meet anytime and this notion that *"the Executive Board can also use the flexibility that is embedded in the programme in order to actually deliver on the decision that was taken today, which is to use flexibility in order to significantly increase our purchases".* But we think last week's decision raises two questions (at least).

First, how much last week's "rigidification" of the decision-making process reflects internal disagreements? Our understanding of PEPP – backed by the legal documentation of the instrument – was that the executive board had wide latitude to use the programme's flexibility. Only increases in the overall size of the PEPP would make Governing Council decisions necessary. The fact that a change in the PEPP pace to respond to changing market conditions entails a Council meeting could signify that the board itself could not reach a consensus on how exactly to proceed.

Second, how precise and quantified the conversation within the Governing Council has been? At one extreme, they could agree on a range for a set of financial market indicators which they would target, the actual speed of PEPP adapting to this target. This would be back to yield curve control. At another, they could agree on a maximum range for the acceleration in PEPP spending, with the possibility that market interest rates rise much higher than what would be consistent with their macro outlook, forcing them into another acceleration later.

It may well be that the conversation has remained more generic than that, with a commitment to "up the ante" on PEPP but without a precise "compass" on the implementation, to borrow a word from Lagarde. We suspect the latter is likelier, or that at least this was the only decision on which a consensus was possible. The next months are likely to be an exercise in "learning by doing". Last week in Macrocast we considered that it would be impossible for the ECB to communicate on the weighting of the various indicators of financing conditions they would look at. Some discretion must be open to the central bank. But internally, some broad model should be available. If, however, the level of consensus within the ECB is too low, such "broad model" may be missing. The market will have to perform a "discovery process", which is conducive to volatility.

Exhibit 4 – Enough dry powder for a while

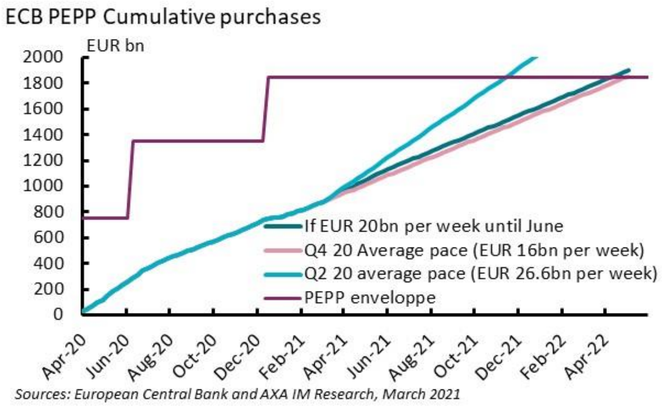
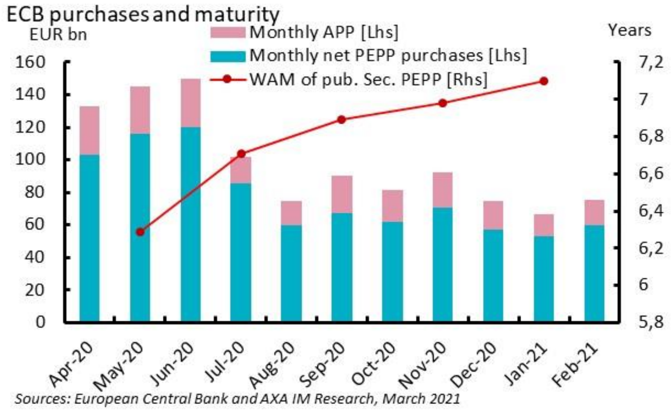


Exhibit 5 – Looking for duration, anyone?



Now, your humble servant is aware of his "nerdiness" and hair-splitting proclivities when it comes to monetary policy matters. None of this probably matters in the short run. The ECB has room to increase its purchases to EUR20bn in Q2 while keeping its envelope consistent with its soft deadline of March 2022 target (Exhibit 4). It can also continue to push the average maturity of its purchases to protect the longer end of the curve from the contagion of the US bond market (Exhibit 5). Still, with this "three-month assessment window", the ECB has created a focus point for the market in June. This may coincide with the peak of "overheating stress" in the US. The ECB may be forced to be more explicit and precise at that point.

How to deal with corporate debt – no free lunch, as usual

When discussing the ECB's holistic approach to assessing financial conditions, Christine Lagarde interestingly mentioned the credit guarantees or moratorium which have been part of the broad "fiscal stance" of most national governments since the beginning of the crisis, stating that a withdrawal of such support would of course deteriorate financing conditions. This brings back in focus the financial position of the corporate sector. We don't think there is a true emergency there, but it is a medium-term concern with potentially far-reaching consequences for the fiscal trajectories of member states.

In the short run, we think pressure is manageable. We focus here on the French non-financial business sector, which even before the crisis was the most "debt hungry" in the Euro area. As can be easily seen in Exhibit 6, even at the worst of the first pandemic wave, corporate deposits rose more than the loans they contracted. Flows on both sides of their balance sheet have slowed down since then, but their net debt position has not been eroded.

In Exhibit 7 we propose a "macro" proxy of businesses' liquidity position: their sight deposits, minus their stock of debt falling due within the year, which we divide by their pre-pandemic production. **As of January 2021 (latest available data), French businesses held liquidity buffers worth more than 3.5 times their average monthly production, against 2.5 times a year before.** This suggests that the relapse into recession in Q4 2020 did not seriously dent the short-term financial position of corporates. This should provide them some capacity to re-start when the economy re-opens, and the government stops substituting itself – in some large sectors – to corporates in paying fixed costs (in particular via in-work unemployment benefits).

Exhibit 6 – From loans to liquidity buffers

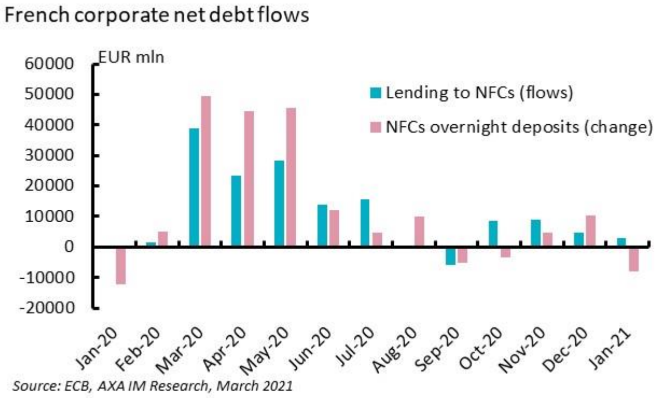


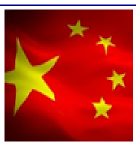
Exhibit 7 – Liquidity position still better than pre-pandemic

Still, even if there is time to deal with it, we cannot merely bat away the structural impact of the rise in corporate debt on firms' decisions, namely investment and productivity growth. Still focusing on France, a recent report by the Conseil National de Productivité provides a thorough analysis of the mechanisms at play. In terms of policy recommendations, the authors propose to encourage banks to voluntarily reduce the value of corporate debt, to protect in the long run the value of their claims, possibly with a form of government subsidy.

An issue there is that public finances are already on the hook. In France, the cumulated flow of bank loans to businesses rose by EUR139bn since the beginning of the pandemic. State-guaranteed loans account for the lion share of this rise (EUR130bn), covering up to 90% of the losses. This has created a potential conflict of interest. A voluntary restructuring which would reduce the credit institutions' claim by more than 10% would cost them more than the full default of the borrower, since the latter would trigger the government guarantee. This is not specific to France: most European countries have extended generous state guarantees to business loans.

Ultimately, from a collective welfare point of view, we are faced with a tricky calculation: is the medium-term cost on corporate productivity and capex stemming from the accumulation of emergency debt during the pandemic higher than the cost of transferring this debt to the public sector, with the ensuing rise in risk-free interest rates and/or eviction of more productive government expenditure? The latter impact would not show up quickly either, thanks to the willingness of central banks to keep government funding costs low, but this can't be eternal.

In our opinion, some "financial engineering" solutions could help. An acceleration in securitization, to take the risk off the banks' balance sheet could help alleviate the ongoing tightening in credit standards which could ultimately impair the recovery. This could take some government incentives, but with a smaller guarantee level than at the peak of the pandemic, together with a dedicated quantitative easing programme by the ECB, which would commit to reinvest this component of its balance sheet for longer than the PEPP. More fundamentally, the ongoing efforts to drive corporate funding away from debt origination towards equity are obviously steps in the right direction. None of this is as spectacular as the "debt cancellations" proposals we see flourishing again in the commentariat, but they may ultimately be less harmful.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• US passes \$1.9tn stimulus, Tsy Sec Yellen states direct payments should begin to be received by households this weekend • CPI inflation rose to 1.7% (from 1.4%) in Feb as expected, but core inched lower to 1.3% • Weekly consumer confidence rises towards Sept and Nov post-Covid highs • Jobless claims continue to fall, JOLTS survey reaches highest since February	• Fed meeting. No policy change expected, updated forecasts to account for stimulus, 'dots' used to anchor market expectations and decision on supp. leverage ratio (SLR). • Retail sales (Feb) – Jan's huge 5.3% m/m rise further lifted GDP outlook, modest dip expected • Empire and Philly Fed surveys (Mar), plus IP (Feb) to gauge manufacturing boost
	• EMA approved the single-shot J&J vaccine • ECB showed discomfort with the current yield levels and pledged to significantly increase its PEPP purchases- but linking this decision to quarterly forecasts undermines PEPP's flexibility • EA IP surprised to the upside at +0.8%mom	• Keep an eye on the results of German regional elections (14 March) and CDU reaction • Dutch elections (15-17 March) likely to be followed by protracted coalition negotiations • Final EA February HICP to give details on the stronger than expected core inflation print • Watch out for ECB speakers
	• UK GDP -2.9% in Jan in lockdown 3.0, better than expected and we raise our full year GDP forecast to 5%. Services less bad fall and construction rose, manu fell more sharply • BRC retail sales consistent with Feb bounce in sales after sharp drop in Jan • RICS survey records some cooling	• BoE meeting. No policy changes. BoE likely to stress slow policy reaction to better conditions to address tighter financial conditions. But generally wait-and-see amidst uncertainty • GfK consumer confidence (Mar) has remained relatively firm so far despite 3rd lockdown
	• Feb economy watchers poll rose to 41.3 from 31.2 • Q4 GDP 2nde estimate has been revised down to 11.7%qoq ann from 12.7% • March primary consumer sentiment index rose to 40.3 from 35.84 • Feb Corp good price rose by 0.4%mom	• January machinery orders should slow down after an important increase in December (+5.5%mom) • February trade figures to assess any distortion from the Lunar New Year
	• Expectation-beating credit and PPI data suggests industrial-sector momentum remains strong	• Upcoming activity data to show uneven impacts of the "staying-put" policy during the lunar new year
	• Some higher inflation surprises are being recorded on the back of higher commodity prices. So far, mostly within CB target bands but given weaker FX and given higher UST, some EM need to front load rate hikes • South Africa Q4 2020 GDP expanded 1.5%qoq still 4% below pre-Covid levels (-7% for 2020)	• CB meeting in Indonesia Taiwan Russia (expected on hold) hikes expected this week in Turkey (100bps) and Brazil (50bps) • Feb CPI for Poland • Jan IP for Colombia • Q4 2020 GDP for Chile Uruguay

Upcoming events		
	US :	Mon: Empire State mfg survey (Mar); Tue: Retail sales (Feb), IP (Feb), Business inventories (Feb); Wed: FOMC announcement.; Thu: Phili Fed Index (Mar), jobless claims, Leading index (Feb)
	Euro Area:	Tue: Econfin meeting, Ge ZEW survey (Mar), Fr, It HICP (final, Mar); Wed: EA19 CPI (final, Feb); Fri: Ge PPI (Feb)
	UK:	Thu: MPC decision (unchg, 0.1%, £895bn); Fri: Gfk consumer confidence (Mar), PSNB ex-banking groups (Feb)
	Japan:	Sun: Private 'core' machinery orders (Jan); Tue: IP (final, Jan), Trade balance (Feb); Thu: CPI (Feb); Fri: BoJ announcement
	China:	Mon: Fixed asset investment (Feb)

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