Contrasted Expectations

86 – 12 April 2021

Key points

- Market-based US inflation expectations have stopped climbing, in contrast with the message from businesses and consumers, contributing to a stabilization of the US bond market. We think this is a pause and that the US curve will steepen further as the credibility of the Fed's Average Inflation targeting strategy is questioned.

The US bond market has stabilized over the last two weeks around 1.70% for a 10-year treasury note after the significant rise in long-term yields triggered by Joe Biden's victory. Market-based inflation expectations have stopped climbing, in contrast with the message sent by businesses and consumers alike in the recent surveys.

Just as we explored the information content of businesses inflation expectations a few weeks ago, this time we turned our gaze to households. The latest Michigan survey suggests that consumers' inflation expectations for the next 5 years have rebounded to their long-term average for the first time since 2014. We suspect this can be explained by the recent public debate around the risks of "overheating" the Biden emergency stimulus could trigger. The frequency of queries on the Internet reflects the emergence of an "inflation anxiety" in the US. These phenomena tend to be self-fulfilling. We show that in a simple model, the Michigan survey, alongside the unemployment rate, is a good predictor of actual core consumer prices. With the two variables pushing in the same direction now, and business survey continuing to reflect a rise in price pressure, an acceleration in core inflation is very plausible in the coming months, beyond the expected base effects. This will raise questions on the credibility of the Fed's Average Inflation Targeting framework, pushing real rates up.

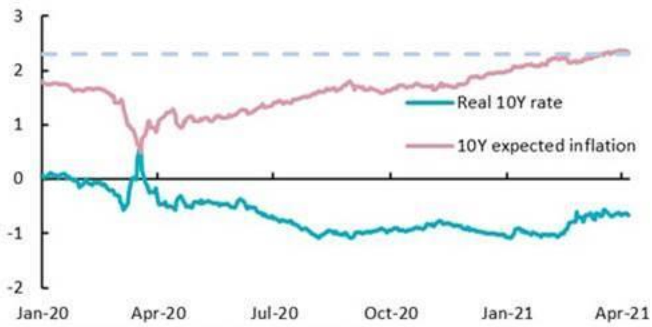
This is one of the key elements which make us believe the current stabilization in US yields is merely a pause and we continue to expect the 10-year rate to hit 2% in the coming months. The market is probably taking stock of the risks of yet another wave of Covid before collective immunity is reached, despite the speed of the US vaccination programme. The prospect of tax hikes funding at least partly the newly unveiled investment plan by the US administration may also curb market enthusiasm for Biden's fiscal activism. But even if the Democrats have their way on this – and contrary to the consensus view until last week, it seems the Senate could use the "reconciliation process" more than once during a fiscal year, reducing the need for bi-partisan support – the tax hikes would be back-loaded, and the supply of US treasuries would rise significantly anyway. True, by year end the US economy may face a complicated moment when the emergency stimulus fades and the mechanical effect of the post-pandemic reopening is absorbed, because the investment plan is unlikely to provide the same impetus. Yet, in the months ahead, the coincidence of higher inflation and higher debt issuance still creates some space for another curve steepening.

Unexpected pause

US long-term yields have stopped climbing over the last two weeks. The market-derived 10-year inflation expectations have been hovering around 2.30% since mid-March, after rising by 70 basis points following Joe Biden's election. Incidentally, the current level is consistent with the Fed's target, taking on board the 30-bps usual gap between the consumer price index (the reference for the inflation -indexed treasury bonds) and the consumption price deflator (the Fed's favourite measure of inflation). Real rates have also stabilized, at around -65 basis points (see Exhibit 1). Even if the Fed would probably be tolerant of some additional rise in yields, this must bring some comfort to the FOMC, since **such configuration – long-term inflation expectations re-anchored at the central bank's target, stable real rates – can be taken as a signal that the market is endorsing the Fed's stance, or in other words that the central bank is credible.**

Exhibit 1 – a pause in the rise in long-term yields

Breakdown of US 10Y yield



Sources: Macrobond and AXA IM Research, April 2021

This pause is nonetheless surprising since indications the US will soon go through an "overheating phase" have on the whole been accumulating lately. Indeed, the latest macro data releases confirm the US economy is improving fast. The March payroll report was very encouraging, with 916,000 more jobs, accelerating from an upwardly revised 468,000 in February. True, the gap relative to the pre-pandemic level remains quite significant (5.5%) but two third of the job losses have now been recovered from the trough of March 2020. Slack is still plentiful in the US, but it is likely that the Congressional Budget Office latest estimate of the output gap was too pessimistic. Based on the historical relationship, the unemployment rate now back at 6.0% is consistent with an output gap at -1.5% in Q1 2021, against a CBO forecast at -2.3%. Beyond the dataflow, with Biden unveiling his medium-term investment plan in excess of USD 2trn, investors should factor in an even larger fiscal support to the US economy post-normalization, fuelling additional pressure on prices.

A gap is appearing between non-financial agents – businesses and consumers – who are increasingly worried about rising inflationary pressure, and investors, who after initially reacting faster to the signals of a rebound in consumer prices are now taking a "pause to reflect".

If you talk about it long enough….

Let's start with the perceptions outside the "financial sphere". Inflation expectations in the US non-financial sectors continue to rise. The price component of the Services ISM index has shot up again to reach 2 standard-deviations above its long-term average in the March batch (see Exhibit2). We discussed in Macrocast already how this indicator has a decent predictive power on core inflation on a 6-month horizon. This week we take a hard look at households' inflation expectations. In the latest Michigan survey, respondents put inflation over the next 5 years at 2.8%. Households always tend to overstate price pressure, but the March survey exceeded its long-term average for the first time since 2014. It is a "noisy" series, but when smoothed over three months the recent trend is unmistakable (see Exhibit 3).

Exhibit 2 – Still climbing

Exhibit 3 – Back to long-term average

The causes of this rebound are not immediately obvious. Indeed, families tend to derive their inflation expectations, even over a seemingly long horizon, from their observation of the most recent price developments. While headline inflation has accelerated from the trough of mid-2020 (0.2%yoy in May) but at 1.7% in March 2021, it is still markedly below the pace hit before the pandemic (above 2% between November 2019 and February 2020). Something outside the actual developments in consumer prices is affecting households. **We suspect that the public debate on the timeliness of the additional fiscal stimulus pushed through Congress by Joe Biden against the risks of "overheating" is having an impact on how households look at the likely trajectory of consumer prices.**

To get a sense of the importance of the inflation theme in popular preoccupations, we look at the frequency at which "inflation" and "deflation" are researched on Google (see Exhibit 4). There was some increase in the number of queries for "inflation" in the US at the worst of the pandemic's first wave, but at the time there was one for "deflation" as well (although from a much lower level). The bigger jump in queries about inflation since the end of 2020 is quite visible, while this time the "deflation theme" has returned to its pre-pandemic level. There has been some decline in the last 2 weeks, which coincide with the Biden plan being endorsed by Congress, possibly taking the temperature down in the press and on social media on the "overheating theme", but the frequency of queries remains much higher than before the elections. Google trends offers also the possibility to rank countries according to the frequency of researching a subject (see Exhibit 5). Judging by their activity on the Internet, **Americans are much more preoccupied with inflation than Germans, which may be counter-intuitive, and the gap has widened lately.**

Exhibit 4 – Internet is bad for your inflation anxiety

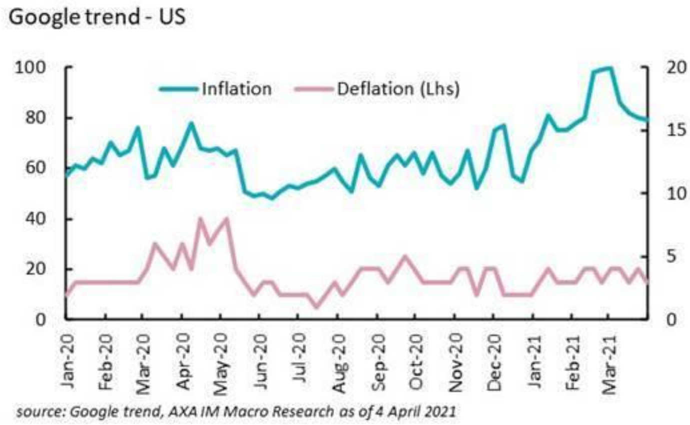


Exhibit 5 – who's the most afraid of inflation now?

Country ranking for researching "inflation" on Google	US	Germany
08/03 - 14/03 2020	28	40
25/10 - 31/10 2020	23	30
08/03 - 14/03 2021	12	33

source: Google trend, AXA IM Macro Research as of 4 April 2021

The next step is to check whether this "inflation anxiety" at the household level can be a strong predictor of an actual acceleration in consumer prices. For this we estimate over the last 20 years a very simple "augmented Phillips curve" model in which observed core inflation is explained by (i) the unemployment rate and (ii) the expected inflation for the next 5 years taken from the Michigan survey, with both variables lagged by 6 months. While the equation paints a "too stable" picture of inflation, it still captures the main inflexion points (see Exhibit 6). Unsurprisingly, the cyclical variable (unemployment) provides more of the variance in observed core inflation, but the 2016-2018 period is interesting. The drop in the long-term inflation expectations of households captured by the Michigan survey helps to explain why observed inflation remained so tame at the time despite the decline in the unemployment rate (see Exhibit 7). Since both variables are "pushing in the right direction" now, it is not surprising to see that our model would predict a core inflation rate of 2% by September 2021, up from 1.3% in March.

Exhibit 6 – Self-fulfilling prophecies?

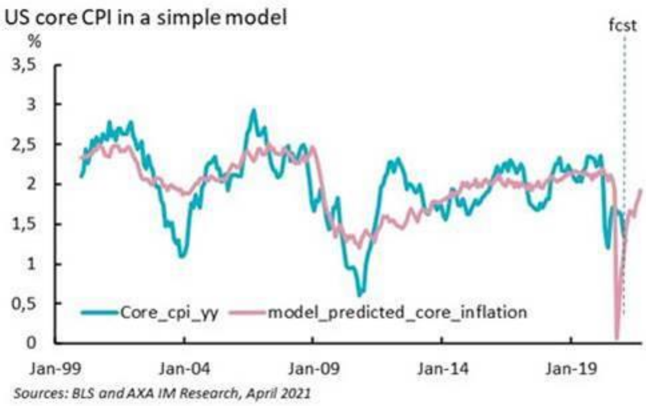
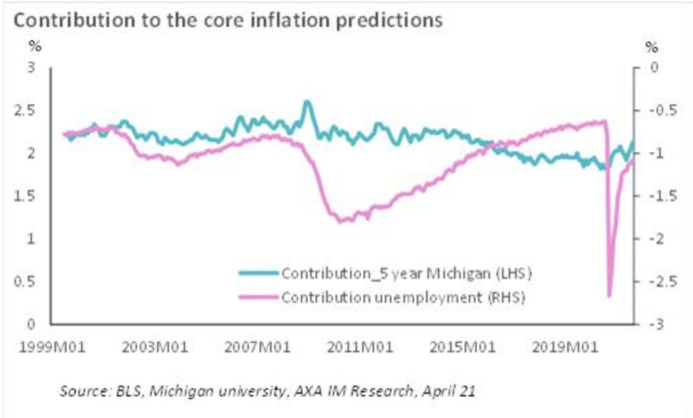


Exhibit 7 – How the two variables affected core inflation



Safe haven in sight, but still some pitfalls to navigate

So, what we know is that US businesses and households alike are nervous about the future path of inflation, and that this is normally consistent with an actual acceleration in core consumer prices within a few months. We have been arguing for a while in Macrocast that economic agents could be at the same time forward-looking and short-sighted. These surveys do not tell us much about how long such an acceleration in consumer prices could last. Our baseline has always been that a proper "regime change" post-Covid was unlikely, at least as long as the institutional set-up, in particular the wage-bargaining process, is not fundamentally altered, but we are also of the view that the market "would not take chances". What has changed in the last few weeks?

Financial agents may be revising their view on the balance of risk in the short run when it comes to the impact of the pandemic on the macro outlook. The US vaccination programme so far has been an undeniable success. We provide a simple illustration of this in Exhibit 8. We look at the inoculation figures in the week to March 31st – to avoid the disturbance created by the Easter break – and look at how quickly countries could have more than 50% of their population having had at least one shot. If the US manage to maintain the pace, this could be achieved in early May. Before the variants emerged, achieving this level would have got the US close to "collective immunity". Vaccinating 50% of the total population starting with the oldest is equivalent to more than 2/3 of the population above the age of 20, and one must also take on board the proportion of the population with natural immunity (having been infected and recovered). Yet, the country is not fully out of the woods.

Exhibit 8 – Getting there…

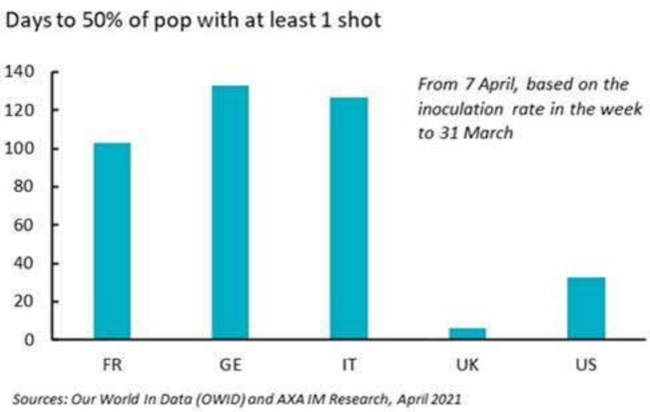
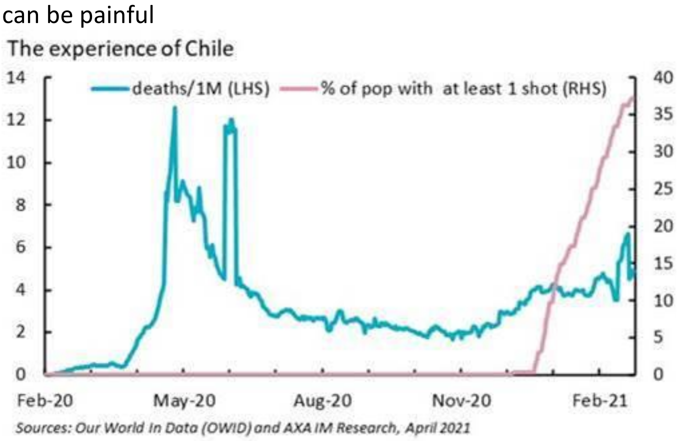


Exhibit 9 – …But Chile suggests "dropping the guard" too soon can be painful



The US incidence rate fell to a trough at 162 per million in the 7 days to 23 March, the lowest level since October, but a rebound has been observed since then (to 206 per million in the 7 days to 10 April), coinciding with the quick reopening in many states. An acceleration in the number of cases would not be a source of concern per se if the level of immunity was high enough to protect against severe forms of the illness but hospitalizations are also on the rise while very recently (and hence tentatively), casualties have started accelerating again (2.96 deaths per million in the 7 days to April 10 from a trough at 2.33 per million in the 7 days to 6 April).

There is a "chain of lags" to consider. Covid-related deaths today are the result of infections which occurred in many cases several weeks ago, and since vaccines take several weeks to deliver their full impact on immunity, the current mortality rates are not representative of the level of protection offered by the current vaccination rates. Still, warnings of the US authorities not to "drop the guard" too quickly to avoid another episode of pressure on the healthcare system just before collective immunity is within reach probably resonate with investors who may curb a bit their enthusiasm about an accelerated comprehensive reopening of the US economy which was a dominant theme just a few weeks ago. It seems a rebalancing is underway, with "peak optimism" on vaccination maybe fully priced in in the US, while in Europe the pessimism of the last few months may now look excessive. An acceleration in vaccination is now well underway and could – if maintained – deliver collective immunity at some point in Q3.

Still, the example of Chile, lauded for the quick delivery of its vaccination programme, probably plays into the hands of the bears. The country is ahead of the US in terms of percentage of its population having received one or two shots (respectively 38.5% and 24.3% of the population for Chile, against 34.8% and 20.4% for the US on 10 April) but restrictive measures had to be implemented again in Chile to curb a rebound in mortality (see Exhibit 9). A debate has started on whether the Chilean experience could be explained by their reliance on Sinovac, a Chinese vaccine, after the head of China's Centre for Disease Control stated that the agency "was considering how to solve the problem that the efficacy of existing vaccines is not high". The US is in a very favourable position given its reliance on the vaccines which so far have avoided controversies, and which have met few logistical hurdles, but the developments in the rest of the world may trigger some caution even there.

The political economy of the infrastructure plan

Beyond the short-term "pandemic outlook", we think investors may have wanted to pause on the "race upward" on US treasury yield to digest how Biden's investment plan could be funded. Until last week, the dominant storyline was that having used the reconciliation process once already in this fiscal year to get its short-term stimulus through Congress, Biden had to choose between either trying to find some bipartisan ground or wait until the end of the year to try to get it through with support from the Democratic caucus alone. Given the refusal of the Republicans to condone many aspects of the investment plan and contemplate any rise in tax to fund it, the most Biden would get in the months ahead was a package limited to the consensual spending items (e.g., road infrastructure) and excluding the green items, but crucially without any rise government resources. Now that the Senate parliamentarian has opined that reconciliation could be used more than once per fiscal year, the prospects of a big spending plan, backed by a significant rise in income tax for the wealthiest and a gradual hike in corporate tax from 21% to 28% (albeit remaining below the 35% rate at the beginning of Trump's mandate) are rising.

Biden's investment programme is spread over 8 years. Assuming a linear distribution, this would be consistent with disbursement of 1.25% of GDP every year. Not bad, and this could obviously boost GDP growth, first on a cyclical basis (raising capex and hiring) and then structurally (the investment package would boost productivity). However, the more the boost is offset by higher tax, the lower the overall multiplier effect – and the impact on the net supply of treasury bonds. The perspective of higher corporate tax rates may have become even more plausible after the US administration made a move on the international stage which signals it "means business" on the matter.

The end of the "race to the bottom" on corporate tax?

The Financial Times reported last week that the US Treasury Department has made a new offer in the ongoing negotiations at the OECD on fighting the "race to the bottom" on corporate tax. Instead of looking for a broad "once and for all" solution, new harmonized rules would apply only to the top 100 world companies by turnover and profit – i.e., including the GAFAS. This would apply to the two pillars of the OECD's framework. Pillar 1 focuses on changing the source of taxation, from the country where profits are booked to the country where the profits are generated. Pillar 2 would be a minimum corporate tax rate binding to everyone.

Biden's offer would help him fight accusations – rife in the US these last few days – of undermining the competitiveness of the US as a corporate headquarter with his plan for the corporate tax. This would go against the interests of the major US companies, but this would fit with his general discourse on supporting "middle America". This goes even beyond short-term political expediency and gets us back to what we think is the core of "Bidenism": rolling back on the Democrats' embrace of the Washington consensus – fiscal prudence, deregulation, free trade – under Bill Clinton to re-anchor it in a Keynesian tradition established between the New Deal and Johnson's "big society". Shifting some of the burden of funding the welfare state away from labour back to profits, without fear of revenues leaking to foreign constituencies, would be consistent with this strategy.

The EU will find itself in a peculiar position. France and Germany in particular have been pushing for pillars 1 and 2. Smaller countries with lower corporate tax rates such as Ireland have argued in favour of the OECD negotiating framework, but in our opinion more as a decoy to avoid that the EU would go alone on setting up its own minimum benchmarks and thus threaten Ireland's 12.5% corporate tax rate and massive impartations of foreign profits, in the hope the OECD efforts would go nowhere. Dublin retains a powerful nuisance capacity: decisions on tax at the European Council still require unanimity. Still, the small countries would probably pay a high political price for obstructing a global agreement on tax which would likely be very popular with public opinion.

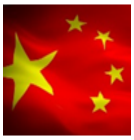
All in all, even if the negotiations are likely to remain bogged down in complex technical issues – determining the national sales for instance – we should probably operate under the assumption that the trend in corporate taxation will go upward, especially in the context of massive public debt inherited from the pandemic and little appetite to raise payroll and income tax. In any case, US Republican Senators should take this seriously.

The way is still up on yields (for a while)

The red-hot question on the markets right now is whether the stabilization in US long-term yields is merely a pause on an ascending trend or "a new normal". Bond bulls often observe that US long-term yields are now not far from the long-term level of the dividend yield on the US market (1.88% on average since 2000 on the S&P500). We stick to our view that the US 10 year will first hit 2% in the coming months, before easing back temporarily to 1.75% by year end (in our forecasts we would be back to 2% in late 2022).

Why this "hump shape"? While we agree that by year end the market will have to digest a US fiscal stance which is going to be much less supportive of the economy as the emergency stimulus fades, we still expect the investment plan to be a "net positive" on activity and – maybe more fundamentally in terms of impact on the bond market – a significant source of additional debt issuance. Indeed, even if Janet Yellen has her way and a substantial part of the plan is funded by a higher corporate tax, the tax hikes would be backloaded, with a horizon of 15 years. If the plan goes through Congress this summer, we think the market will take notice. This is likely to coincide with strong inflation figures, which will rekindle discussions on the credibility of the Fed's Average Inflation Targeting framework, pushing real rates up. Of course, businesses and households can be wrong together, but the parallel rise in their inflation expectations is striking.

The US bond market will face massive auctions in the coming weeks. We have been arguing for a while that non-resident investors will ultimately come to the rescue of the US treasuries, but they may want to see first how these flows are absorbed locally – especially after the Fed chose not to prolong the SLR exemption - and get a better sense of Biden's next moves on the fiscal front. Of course, another Covid wave in the US - despite the speed of the vaccination programme – could throw a spanner in the wheels of another bout of curve steepening, but we think there is still some space in the months ahead.

Country/Region	What we focused on last week	What we will focus on this week
	• March FOMC minutes, consistent message: reacting to actual not anticipated data; relaxed on yield gains and inflation expectations • President Biden speech pitching $2.3trn spending package, part financed by corporate tax increases. Related, Tsy Sec Yellen discusses digital and international tax proposals • ISM non-mfg sets record high 63.7 in March • Weekly jobless claims rise above Mar avg	• CPI inflation (Mar) expected to jump to 2.5% as base effects begin to impact • Retail sales (Mar), bumper 5.0% mom consensus forecast with risks to upside • Industrial output and business inventories, help finalise Q1 outlook. We forecast 6.6% annualised (risks seen to upside) • Michigan Uni consumer sent, inc 5-10y inflation expectations at 2.8% in Mar
	• Mixed signals from German data: factory orders and exports were strong, while IP disappointed in February (-1.6%mom), contrasting also with upbeat business surveys • Italy extended restrictions until end of April • ECB minutes confirmed divisions within GC on reaction function, confidence on the outlook	• Informal meeting of Economic and Finance ministers to discuss implementation of the Recovery and Resilience Facility and the financing of Next Generation EU • EA IP likely to contract after disappointing numbers in Germany and France (-4.7%mom) • Schnabel, De Guindos and Panetta to speak
	• PM Johnson approves re-opening on 12 Apr • Vaccinations slow over Easter weekend • Services PMI rises to 56.3 (lower than preliminary est), but robust in March • Construction PMI reaches 7-year high • RICS housing survey reflects renewed impetus after Stamp Duty holiday extension in Budget	• GDP Feb, expected +0.7%mom, contributing to Q1 forecast of -2.4%, including broader sector output figures (IP, services and construction) • Trade (Feb), watch for rebound in EU exports after 40% drop Brexit impact in January • BRC retail sales monitor (Mar) – any rebound • BoE Credit Conditions Survey Q1
	• New restrictions have been announced in big cities, three weeks after the end of the SoE • Feb retail sales is up at -1.5%yoy from -2.4% • Feb prelim IP declined by 2.1%mom • Q1 Tankan surveys have improved. Big manuf back in positive territory while Svcs struggle	• Monitoring the evolution of vaccination as only 0.8% of the pop receive one dose • March corporate price is expected to rise • Feb machinery orders should rebound • The impact of renewed restrictions on April IPSOS consumer sentiment is uncertain
	• PMI suggests strong sequential recovery in manufacturing and services activity following a slow start to the year due to COVID resurgence	• Q1 GDP to show a strong, close to 20%, year-on-year growth due to a low base effect
	• Central Banks were on hold in India (1trnINR bond purchases program), Poland, Peru • Manufacturing PMIs in March suggest an ongoing acceleration in global manufacturing activity across all major production hubs	• Elections on Sun April 11th in Peru and Ecuador • CB meeting: Korea (on hold), first meeting for the new governor in Turkey expected on hold • March CPI in India, Argentina • Feb IP in Turkey, Russia, Colombia • Q4 2020 GDP in Costa Rica • Q1 2021 advance estim. In Singapore

Upcoming events	**US :**	Tue: CPI (Mar); Thu: Empire State mfg survey (Apr), Phili Fed index (Apr), Retail sales (Mar), Jobless Claims, IP (Mar); Fri: Michigan consumer sentiment (prel., Apr)
	Euro Area:	Mon: EA retail sales (Feb); Tue: Ge ZEW survey (Apr), It IP (Feb); Wed: EA IP (Feb), Sp HICP (final, Mar); Thu: Ge, Fr, It HICP (Mar), Ge CPI (final, Mar); Fri: EA CPI (final, Mar)
	UK:	Tue: BRC Retail Sales Monitor (Mar), Monthly GDP (Feb), IP (Feb)
	Japan:	Wed: Private ‘core’ machinery orders (Feb)
	China:	Tue: Exports, Imports (CNY, Mar); Fri: Fixed asset investment (Mar), GDP (Q1), IP (Mar), Retail sales (Mar)

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