AXA Investment Managers

Research & Strategy Insights

Consistency Check

100 – 19 July 2021

Key points

- ECB to make its forward guidance consistent with the strategy review this Thursday
- The US inflation spike has already shrunk the "price level gap" accumulated since 2012 by more than half.
- First foray into the EU's decarbonation proposals: it's going to cost.

The summer break is coming late for the European Central Bank (ECB), since this Thursday's Governing Council is likely to be the occasion of a consistency exercise with the strategy review unveiled last week. We expect some changes in forward guidance, with a shift from an outlook to an outcome-based approach, i.e., making future policy moves more dependent on changes in actual inflation data than on any forecast upgrade, as well as a recognition of the possibility of allowing inflation to overshoot. However, we think we will have to wait longer – September or even December – to get clarity on how much quantitative easing will be recalibrated once Pandemic Emergency Purchase Programme (PEPP) is over, given the level of division within the Council.

While the ECB is still grappling with a rate of inflation still massively below target (core inflation stood at 0.9%yoy in June), above-expectations and above-target prints continue in the US. In the June batch we see no pattern change from the April and May developments: the spike is still driven by idiosyncratic moves in a small number of items. The latest Michigan survey of consumers' own price forecasts still don't provide a "smoking gun" on a de-anchoring of inflation expectations. Still, the Fed must be happy it chose "flexible average inflation targeting" to justify some overshooting rather than the normally more dovish "price level targeting". Indeed, the current spike has already cut by more than half the price level gap accumulated since 2012. Looking ahead, this gap would be closed by December 2021 if the monthly gains in core inflation stood at only half the pace seen since March.

No early summer break for the European Commission either, which released last week its detailed strategy to deliver on the pledge to reduce carbon emissions by 55% by 2030, as an intermediary target before reaching net zero in 2030. There are many different levers the Commission wants to push, but a lot of the proposals coalesce to significantly raise the price of carbon further, while affecting a wider array of domestic sectors as well as imports. The income distribution ramifications of the package are far-reaching. This will undoubtedly trigger painful debates in the European Council and the European parliament. Last year, the European Union (EU)'s next generation plan harnessed the fight against climate change to deliver a growth-friendly fiscal push. Focus is likely to shift now on the transitory costs, even if climate change is such a massive negative externality that our "pain threshold" during the green revolution should be high.

ECB: strategy review guiding the guidance

Our take on the ECB's strategy review last week was that it created the intellectual underpinning for the possibility to maintain an extraordinarily accommodative monetary stance long after the end of the pandemic crisis if need be. There was no hint however at whether a consensus existed in the Governing Council on (i) the appropriateness of such stance itself, and consequently what kind of forward guidance the market should receive now and (ii) the calibration of support post-PEPP. It seems Christine Lagarde is intent on pressing the matter onto her colleagues before the summer break, hinting last week at changes in the ECB's communication at this Thursday's Governing Council meeting. **We think we will get some news on the first issue (forward guidance), but also that we will have to wait until September at the earliest to know more about the calibration.**

Technically, the ECB needs to change the wording of its forward guidance anyway, since it has become obsolete after the move to a properly symmetric inflation objective last week. Indeed, the current text reads *"we expect [policy rates] to remain at their present or lower levels until we have seen the inflation outlook robustly converge <u>to a level sufficiently close to, but below, 2 per cent</u> within our projection horizon, and such convergence has been consistently reflected in underlying inflation dynamics*". So as a minimum the reference to "below" must go for consistency reasons. But the ECB is likely to go further than that. Two more shifts are likely in our view.

First, making it clear that "underlying inflation dynamics" – which is there to signal the central bank would see through any exogenous spike – refer to an "outcome", i.e., a string of observed data, rather than an "outlook". Isabel Schnabel, in the speech we analysed last week, mentioned the need to see better inflation prospects being "*<u>visibly</u> reflected in <u>actual</u> underlying inflation dynamics*". Such a move from "outlook" to "outcome" would bring the ECB's communication closer to the Fed's. We are tempted to label this a shift to a Thomasian monetary policy (believing what can be observed only, rather than what can be projected). Core inflation would have to accelerate and get effectively close to 2% for a sustained period for the ECB to ponder a monetary tightening, even if the ECB will probably refrain from being that explicit.

An outcome-based approach goes against decades of central bank tradition, which considers the transmission lags of monetary policy to favour a forward-looking approach. However, when the central bank is up against the effective lower bound on policy rates, the consequences of making a mistake when allowing inflation to be too strong – which could always be addressed with tighter policy later – are less dramatic than those of tightening too soon – since there is little more the central bank could do if its policy move were to send the economy back towards a deflation scenario.

This "risk asymmetry" is one of the reasons why some transitory inflation overshooting should be tolerated in the current circumstances, which is the second shift we expect to see in this week's new forward guidance, albeit in the same non-committal manner as last week: overshooting might be an outcome, a possibility, but it would not be a goal to be effectively pursued.

That gets us to the stimulus calibration issue. Even if the ECB is not actively seeking an inflation overshooting, the latest ECB forecasts for inflation, albeit upgraded, are still markedly lower than before the pandemic. This would in theory imply an intensification of the stimulus, but "doing more" (taking interest rates further down or buying many more bonds every month through quantitative easing in excess of the current envelope) makes the central bank uncomfortable for financial stability reasons. **So, the only realistic adjustment variable left to the ECB is to prolong the current support**, which implies delaying the rate lift-off and maintaining a robust pace of quantitative easing for longer.

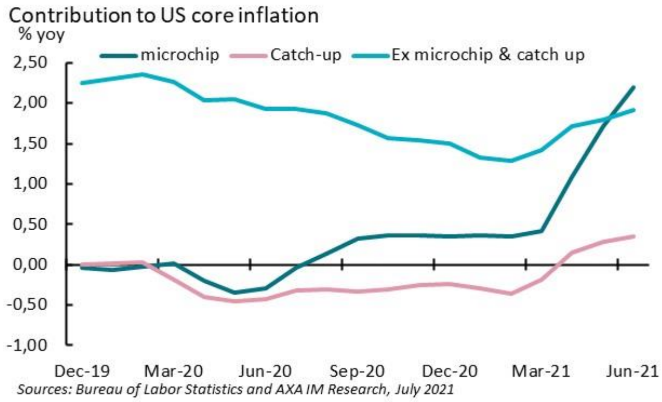
This possibility already exists in the current formulation of forward guidance: March 2022 for PEPP termination is only a soft deadline. We have been discussing for months in Macrocast how the ECB will have to make a decision on upgrading its ordinary Quantitative Easing (QE) programme once PEPP stops. This week, Christine Lagarde could hint at the fact that the "unconventional leg" of its policy arsenal – including QE – would remain "as supportive as needed" long after the pandemic crisis is absorbed even after taking on board the termination of PEPP. This might not move the dial much, however. The market is already starting to focus on the exact quantification of QE next year and beyond. Judging by the “Frankfurt noises” which have transpired in the press last week, highlighting deep divisions within the Council on this matter, we think it is too early for the ECB to get into this. The September forecasts could be a good moment for some elaboration on this front, once the current downside risks triggered by the pandemic resurgence find their ways to the ECB baseline, but we may have to wait until December for clear numbers.

The level and the change

While the EU is grappling with the difficulty to reach its inflation target, let alone overshoot it (core inflation stood at 0.9% in June in the Euro area), the US continues to display quite a bit of “inflation gusto”. Still, the immediate reaction last week of the bond market to the release of yet another above-expectation US inflation print for June says it all: a few minutes of stress, followed by a return to the starting point, once investors had pored over the details.

Indeed, while core inflation accelerated again - 4.5%yoy from 3.8% in May – **the “spike” remains concentrated on a few items displaying even more spectacular, but idiosyncratic, price rises**. Still no “smoking gun” then. In Exhibit 1 we updated our breakdown of US core inflation between the “catch-up”, the “microchip” buckets (12% of the index taken together) and “everything else”. There is no significant change from last month: we can still explain more than 80% of the acceleration since March with these two buckets. True, core inflation excluding these items has been accelerating as well, but the slope is gentle, and the pace is still slower than before the pandemic.

Exhibit 1 – no pattern change in June



The impact of some individual items to aggregate inflation numbers is so big that we probably need to explore this in some details. The price of used cars rose by a whopping 45% year on year in June 2021, alone providing a contribution of 1.6% to core inflation, and is now standing 43% above the pre-pandemic level. A shortage of new cars is the root cause (US production since the beginning of the pandemic has been down 18% relative to the 2019 level), with interesting transmission channels.

The Bureau of Labor Statistics, which computes inflation data, takes its data for the price of used cars from JD Power, the data analytics and marketing company which provides precise valuation data for a wide range of used vehicles in the US. Used cars are sold in a “two-step” market: wholesale prices are determined by auctions – e.g., rental companies selling in bulk – which are the basis for the prices offered by retailers to final buyers. According to JD Power, the number of auctioned units has fallen by 30% since the beginning of the year, as (i) rental companies offloaded a lot of cars in 2020 at the peak of the pandemic, did not rebuild their inventories and so have very little to pass downstream at this juncture; (ii) retailers receiving used cars when selling new ones hold on to them instead of passing them for auctions, given the shortage, which then becomes self-perpetuating; (iii) more cars have been bought outright instead of being leased, which also reduces the quantum of used cars coming back to auctions. The rise in used car prices may be spectacular, but it looks “genuine”, not the product of some statistical artefact.

What usually stops this kind of exogenous price shocks from morphing into persistent inflation is the reaction of consumption. Despite their recent acceleration in nominal terms, US wages are now falling in real terms. For now, however, the behaviour of actual spending provides no smoking gun either. Retail sales have been quite volatile these last months: the June print has surprised to the upside (+0.6% against a fall of 0.3% expected) but the May one has been revised down to a very low -1.7%. The details suggest a shift away from spending on goods towards services, which is not surprising as sanitary restrictions are lifted, but no clear sign of an aggregate slowdown yet. There is probably more than enough excess saving to protect spending capacity even in the face of surging consumer prices. Still, as the direct impact of the fiscal stimulus fades, consumption behaviour will be a key variable to monitor in the months ahead. In "proper overheating" situations, strong spending and strong inflation go hand in hand and feed each other (rising pressure from demand lifts prices, higher inflation expectations incentivize consumers to spend their money fast). In "inflation spikes", they end up cancelling each other. We may see some of this in the second half of 2021.

For now, **households' inflation expectations remain composed**. Last Friday the release of the University of Michigan consumer survey was expected with some trepidation, but it was no watershed moment. Indeed, the 5-year inflation forecast by individuals inched up from 2.8% in June to 2.9% in July, but this is still below the recent peak in May at 3.0%. Consumers tend to overstate actual inflation, so these figures need to be put in perspective. On average since 2000, people polled by the Michigan survey have expected 5 year-ahead inflation to stand at 2.8%. This is why we prefer to look at this data as a z-score, measuring the moves in number of standard deviations around this average. The July 5-year inflation forecast was only 0.5 standard deviation above its long-term average. For now, Americans seem to buy the "inflation hump" scenario which is the Fed's (and our) baseline. 1 year ahead inflation continues to edge higher, to nearly 4 standard deviations above the average, as people take into account the actual acceleration in prices, but the spread between the 1 year ahead and the 5 year ahead inflation forecast has never been wider (see Exhibit 2).

Exhibit 2 – People expect an "inflation hump"

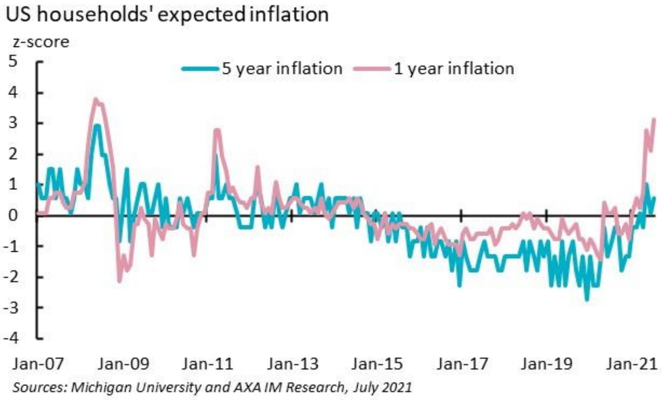
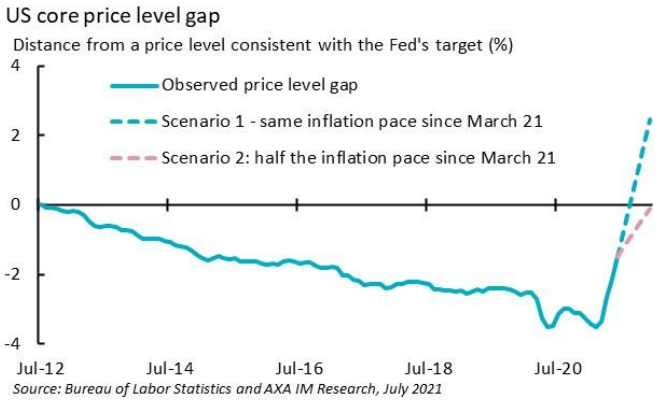


Exhibit 3 – How quickly things can change….



Of course, even if expectations don't seem to de-anchor, the Fed is under pressure given the spectacular inflation prints and Jay Powell had a tough moment at his latest hearing. **In retrospect, he must be relieved the Fed shifted to Flexible Average Inflation Targeting (FAIT) rather than the more committal Price Level Targeting (PLT)**. Under PLT, the central bank should aim at minimizing any "price level gap", i.e., the difference between the actual price level and where it should be if inflation had been on target all the time. This is more prescriptive than FAIT because monetary policy would have to remain accommodative so long as past sub-par inflation has not been totally compensated. In FAIT, past low inflation warrants some inflation overshooting but without a commitment to offset it entirely. If the Fed had chosen PLT, it would be in a delicate situation. Indeed, **the price level gap has shrunk so fast over the last few months that it could be completely closed by the end of 2021 if inflation from July 2021 onward stood at only half the pace observed since March.**

Some statistical explanations are warranted here. Measuring the price level gap is more difficult than it seems, because it is highly dependent on the starting point. In Exhibit 3 we start computing it from mid-2012 onward, since the first half of 2012 had been the last time core CPI had sustained for several months in a row a growth rate above 2%. Since the Fed targets the core Personal Consumption Expenditure deflator, which on trend has been growing 0.3% p.a. more than core CPI, our "targeted price level" is computed by applying a growth rate of 2.3% to the actual price level of June 2012.

Under these assumptions, **the price level gap has declined from -3.4% in March to -1.5% in June (see Exhibit 3)**. Prolonging the rest of 2021 with the trend seen over the last 3 months (0.8% per month as per scenario 1) would get to a 2% excess by December. It is highly unlikely that this will happen. Many items in the catch-up bucket will have finished their normalization in the next few months and JD Power reported the first signals of a slowdown in auction prices for used cars at the end of June. Still, a monthly growth rate in core prices of 0.4% on average between July and December – half the recent pace – would suffice to fully eliminate the price level gap.

This recent experience provides a strong case for avoiding quasi-automatic monetary policy rules attached to strictly-defined numerical thresholds, since even a seemingly "uber dovish" approach – PLT – could ultimately backfire and warrant a monetary tightening very early in a recovery. The argument the Fed can use to justify prudence until its "soft deadline" of a rate lift-off in 2023 – as per the "dot plot" – is the state of the labour market. The Fed made it plain last year, upon shifting to FAIT, that beyond the inflation developments, they would wait until full employment has been restored with a high degree of certainty before normalizing its policy. With total employment still 4% below its pre-pandemic level, the Fed has some breathing space.

Carbon battles ahead

The European Commission released last week a very detailed programme underpinning the EU's heightened ambitions in terms of decarbonation of its economy (a cut of 55% by 2030 – hence the "fit for 55" name - from 40% under the previous framework, as an intermediary target before reaching net zero in 2050). This is **only a step into what is likely to be a quite painful and protracted process through the European Council and the European parliament.** Any quantification of the macroeconomic impact of the proposal will depend on the price of carbon at the time of implementation and too many parameters remain uncertain, but at this stage we would focus on two matters of principle which are likely to shape the political debate in the years ahead.

Let's start with the Carbon Border Adjustment Mechanism (CBAM). This would completely reverse the logic applied so far to carbon pricing in the context of international trade. In the current European Emissions Trading System (ETS), some sectors were protected from "unfair competition" from non-EU suppliers thanks to the allocation of "free allowances" in carbon certificates. This addressed some aspects of "carbon leakage": imposing strict carbon allowances to internal producers which would down the road make them uncompetitive and replace them by even more carbon-intensive external suppliers would ultimately result in a higher global carbon footprint. Still, the EU accepted to lower the aggregate price of carbon *internally* as a result of these free allocations. Under the new system, free allowances would be slowly phased out and the EU's competitiveness would be safeguarded by gradually raising the price of imported carbon-intensive goods.

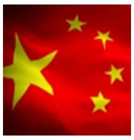
Technically, **this would not work exactly like a customs duty, but the end-result would be similar**. EU importers would need to purchase CBAM certificates at a price equal to the one observed on the ETS market and then surrender them. This would bring the carbon component of any price differential between an EU and a non-EU product to zero. From a macroeconomic point of view, the effect of this shift from free allowance to CBAM would be a rise in the price level in the EU, at least so long as the EU's carbon intensity is higher than that of its suppliers, which is likely to be the case for a long time, given the EU's advance on this matter.

From the point of view of the fight against climate change, it is probably the right approach, since it would incentivize non-EU producers to reduce their own carbon footprint to maintain their share of the massive European market. The EU's own contribution to global carbon emission is already relatively low, even if it accounts for a large part of the accumulated depletion of the world's carbon budget thanks to its historical emissions. The EU's main contribution to the fight against climate change will now probably transit through its capacity to nudge more carbon-intensive partners to "do the right thing" and decarbonize. The CBAM framework would actually explicitly recognize efforts outside the EU (e.g., through a "no double taxation" principle on goods already subject to carbon pricing in the country where they were produced).

Still, and this gets us to our second "issue of principle", **the ramifications of the EU's "Fit for 55" strategy in terms of income distribution are going to be a major headache.** The Commission proposes to move slowly. For instance, on CBAM the framework would first apply in 2023 to a small number of products, with an extension in 2026. Construction and transport would not enter their own version of the ETS framework to be subjected to carbon caps and pricing before 2026. Still, even if it is postponed by a few years, the extension of carbon pricing to a wider array of activities could be felt quite badly by consumers, on top of the rise in import prices triggered by CBAM. Today, only 41% of the EU's emissions are covered by the ETS market. Moreover, the carbon cap under the "old" ETS which controls the quantum of allowances which can be traded, would be reduced at a faster pace, which mechanically should lift carbon prices faster for the sectors already covered.

The Commission has of course recognized the issue and offers to channel a quarter of the revenue generated by the new ETS to a Social Climate Fund which would help cushion the impact of the transition on purchasing power. But the political reaction to the EU's package – echoing an unusual level of division within the Commission itself – has been far from unanimous. We expect very fractions discussions within the EU in the next 2 years, with a focus on how ETS revenues would be recycled and how widely carbon cap systems should be extended, but also with the EU partners, given the impact on the region's foreign trade.

In 2020, the EU has successfully leveraged the green transition to push through a much-needed mutualized fiscal stimulus which will help across several years the member states to deal with the medium-term consequences of the pandemic crisis while at the same time helping then to decarbonize. This was a win-win. Yet, with carbon prices now projected to rise significantly and apply to more sectors, the transitory downward impact on growth becomes more visible. Climate change is such a massively negative externality that accepting some transition costs is well worth the effort, but the nature of politics – and the electoral pace – is not in synch with the decades-long horizon we are dealing with on these matters.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• CPI inflation rose to 5.4% (a 2008 high) and core to 4.5% (1991). Used cars rose 10.8% on the month • Fed Chair Powell delivered semi-annual testimony. Repeated that inflation expected transitory and "a way off" from sufficient progress to tapering • Senate Dem Budget Comm agrees to $3.5trn "fully paid for" spending bill by reconciliation • Retail sales (Jun) +0.6% rise, with control up 1.1% • Cons conf marked sharpest 3-wk drop since Dec.	• US housing market indicators, including existing home sales (Jun), NAHB housing index (Jul) and building starts and permits (Jun) • Weekly consumer confidence measure – to watch for any further weakening • Jobless claims – both initial and continuing claims continue to fall, but at slower pace than markets expected • US PMI releases (Jul, p)
	• EC released its "Fit for 55" strategy with steeper emissions reduction targets, stricter legislation, ETS revision and a CBAM proposal • EA IP has slowed by 1% mom, negatively impacted by supply shortages • Health pass extension in Fr to urge vaccination	• ECB's new forward guidance should be unveiled, but precise wording on overshooting and details on how to get there likely to disappoint as internal disagreement persists • Jul consumer confidence and Flash PMIs to gauge impact of renewed Covid outbreak
	• New virus cases reach 48k, 1.6m self-isolate • BoE's Saunders could vote to curtail QE early, Ramsden hiking conditions may be met earlier • CPI inflation (Jun) rose to 2.5% (core 2.3%), highest since 2018 • Unemp rose to 4.8%, emp slowed to +25k • BoE FPC allows bank shareholder pay-outs	• BoE DG Broadbent and Haskell deliver speeches amidst hawkish turn from others • Retail sales (Jun), we expect another fall in ex-fuel monthly sales after the March/April surge • Preliminary estimates of July's PMIs • Public finances (Jun)
	• The BoJ kept the status quo on its monetary policy tools and forward guidance but unveiled details on its new green funding prog • May final IP has been revised down to -6.8%mom from -5.9%	• June CPI is likely to rise, boosted by a strong energy contribution • June trade figures should slightly progress on a monthly basis • Olympic Games start on 23 July
	• Q2 GDP confirms the anticipated growth rebound, while June activity data surprises on the upside	• The PBoC is expected to keep the Loan Prime Rate unchanged
	• Central banks on hold in Turkey (19%), Korea (0.50%). A first hike delivered in Chile (25bp from 0.50%) in line with expectations	• Central banks expected on hold in SA (3.5%). Another rate hike in Russia expected (50-100bp from 5.50%) • June IP in Poland, Russia, Taiwan • June CPI in SA • First-15 days July inflation in Mexico and Brazil

Upcoming events		
	US :	Mon: NAHB Housing Market Index (Jul); Tues: Building Permits (Jun); Thu: Weekly Jobless Claims (Jul); Leading Index (Jun); Fri: Manu & Services PMI (Jul, p)
	Euro Area:	Tues: Ge PPI Inflation (Jun); Thu: ECB Announcement (Jul); Consumer Confidence (Jul, p); Fri: Ez, Ge & Fr, PMI (Jul,p)
	UK:	Mon: BoE's Haskel; Wed: Public Finances (Jun); Thu: CBI Survey (Jul), BoE's Broadbent; Fri: GfK Consumer Confidence (Jul); Retail Sales (Jun); PMI Survey (Jul ,p)
	Japan:	Tues: CPI (Jun); Wed: Trade Balance (Jun); BoJ Minutes (Jun 17/18), Fri: Manu & Serv PMI (Jul, p)
	China:	Tues: 1yr and 5yr Loan Prime Rate

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