

Top Trends: Financial Fragility

Stagflation on the horizon? Global supply chain disruptions stall recovery

However, it isn't stagflation, but it sure is "M.E.S.S.I."

November 2021



Episode 2



Key Points:

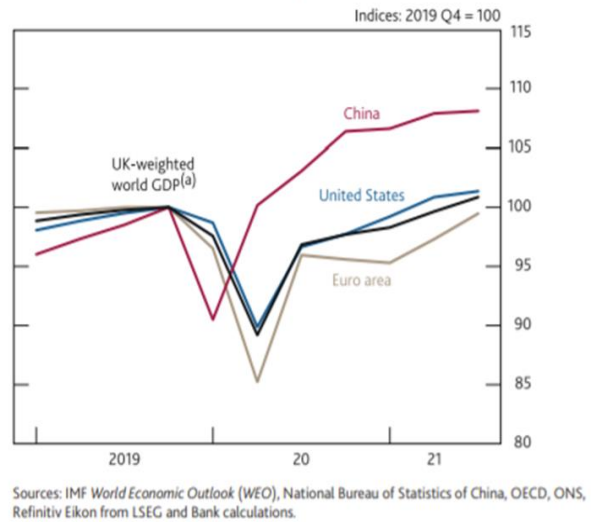
- **Supply chain and inflation headwinds hamper the global recovery.**
- **Supply chain disruptions are unlikely to disappear overnight, but a surge in global corporate capital expenditure in 2021 and a somewhat cooling demand should ultimately alleviate shortages.**
- **In the debate between transitory and runaway inflation, it is supposed that the truth lies somewhere in the middle, with inflation likely to be “sticky but not oppressive”.**
- **It’s not runaway inflation, and it’s certainly not stagflation. In fact, the US economy is going through a bout of “M.E.S.S.I.” inflation dynamics – Moderating Expansion with Sticky Supply-driven Inflation – a rare phenomenon where strong, but cooling demand is met by constrained, but accelerating supply, leading to transitory, yet sticky inflation.**
- **40% of US dollars in existence were printed in the last 12 months.**
- **Policy Tenor Mismatch: Fed uncertainty in the face of sticky inflation is more hawkish.**
- **Higher inflation may be here to stay.**



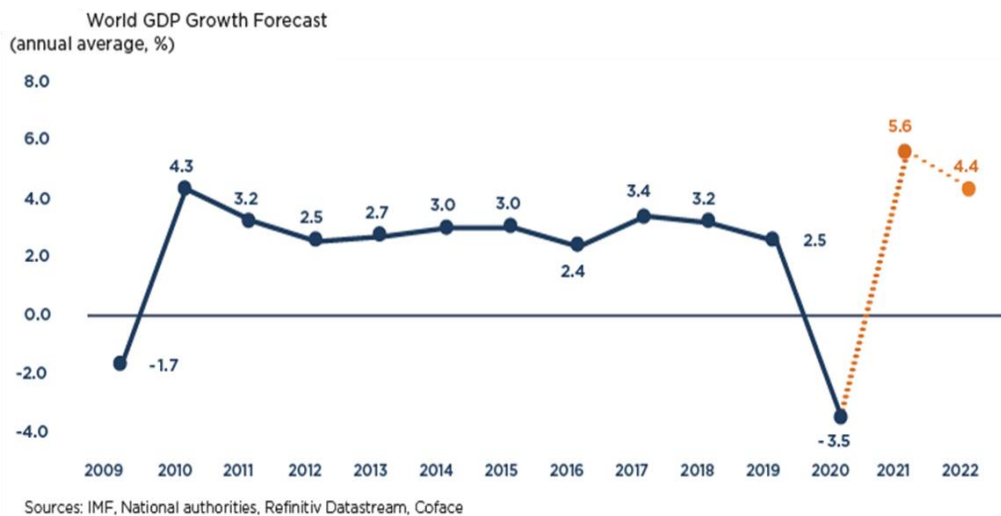
Supply chain and inflation headwinds hamper the global recovery

More than 18 months after the global recession triggered by the COVID-19 pandemic started, the economic recovery continues. This trend owes much to progress in the vaccine rollout over the summer, particularly in advanced economies, allowing for the easing of mobility restrictions. In turn, this is spurring a rebound in consumption of high-contact services, food services, accommodation and recreation. High household savings accumulated last year - as consumer spending on physical goods plunged during the strict lockdowns, and income increased, bolstered by massive government support - are a key factor behind the rebound in household spending in advanced economies. The situation remains heterogeneous in emerging economies: this rebound is benefitting export-oriented countries, while service dependent economies continue lagging.

The recovery in global activity has continued...
GDP in selected countries and regions



Despite the positive outlook, signs that the global recovery is losing momentum are accumulating. Supply chains disruptions due to port congestions, lack of containers and ships, as well as overstretched production capacities have entailed shortages and price hikes, are starting to affect manufacturers’ production and sales across the globe. The mismatch between supply and demand prompted a rise in commodity and input materials prices, which is feeding higher inflation in many countries, as they are passed down to consumers. Headwinds represented by supply concerns, labour shortages, and inflation, alongside the lingering threat of COVID-19, add to the list of risks and uncertainties. Meanwhile, an economic slowdown in China is also contributing to a less favorable recovery momentum.

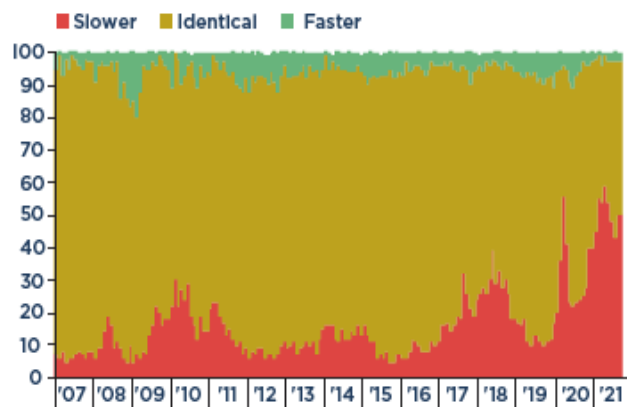




Supply chain disruptions are unlikely to disappear overnight, but a surge in global corporate capital expenditure in 2021 and a somewhat cooling demand (as spending shifts away from consumer goods to high-contact services) should ultimately alleviate shortages. Supply constraints are expected to continue to weigh on output in the near term. Some slowdown in growth would be expected as output returns to around its pre-COVID level in various economies, but the Q4 projection is still weaker than expected in August. **How long supply constraints continue to weigh on global output is uncertain.** The impact of the recent localized lockdowns in Asia is likely to fade quickly. But the imbalance between the demand and supply of some goods could persist for longer. There are some signs that demand has begun to rotate away from goods and towards services. That is particularly apparent in the US where durables consumption has moderated in recent months and high-frequency spending data suggest that social spending, such as on restaurants and hotels, has continued to recover. That process may continue as consumers' demand for durable goods is satiated and the impact of fiscal stimulus wanes, but it could take time. It is expected that some supply constraints will not be resolved until at least Q2-2022, and that some might continue into at least the second half of 2022.

Furthermore, while the recovery is still on track, headwinds are accumulating, particularly on the supply-side of the economy. High level of savings in high-income countries - as consumer spending dropped during the strict lockdowns, and income increased, bolstered by massive government support – prompted a rapid recovery in consumer spending. However, alongside, pandemic disruptions in different parts of the global created breaks in the supply chain. As a result, longer-than-anticipated supply chain disruptions are hampering business activity. Competition for commodities and input goods is strong, hindering industrial production at the global level and, in some instances, having an impact on sales. Despite new investment projects like the construction of new plants, it will take a long time before capacity can be ramped up to meet demand. This is notably true for the shortage of semiconductors, which is impacting a wide-array of industries from the automotive to ICT sectors both in advanced and emerging economies.

Supplier deliveries, survey of manufacturers (% of respondents)



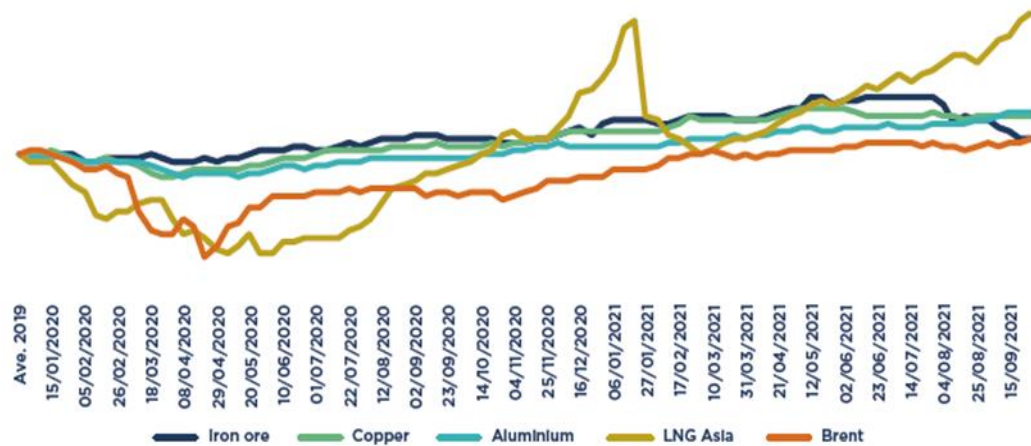
Source: Institute for Supply Management, refinitiv Datastream, Coface

Meanwhile, in a context of imbalance between supply and demand, commodity prices, input costs and freight rates have surged since the summer of 2020. Many commodities broke record levels or reached multi-year highs. This has been notably the case with energy - particularly as European and Asian gas prices soared - and metals prices. The recent rise in gas prices reflects both limited supplies, reflecting disruptions to production due to unplanned outages and delayed maintenance, and strong global demand as economies have reopened. Non-energy commodity prices have also increased a little further since August. Widespread price increases for commodities and inputs have also translated into increasing consumer prices. This echoes a rise in inflation observed in most parts of the globe, most notably in the US, where the inflation rate measured by the Consumer Price Index has also been hovering a 13-year high of 5.4% in the last four months



to September. While some of the current price pressures continue to be linked to supply chain disruptions and one-off shocks (e.g., temporary changes in the VAT, higher taxes on CO2-emissions, droughts, export restrictions), some concerning higher production costs could insert inflation for longer than initially envisioned.

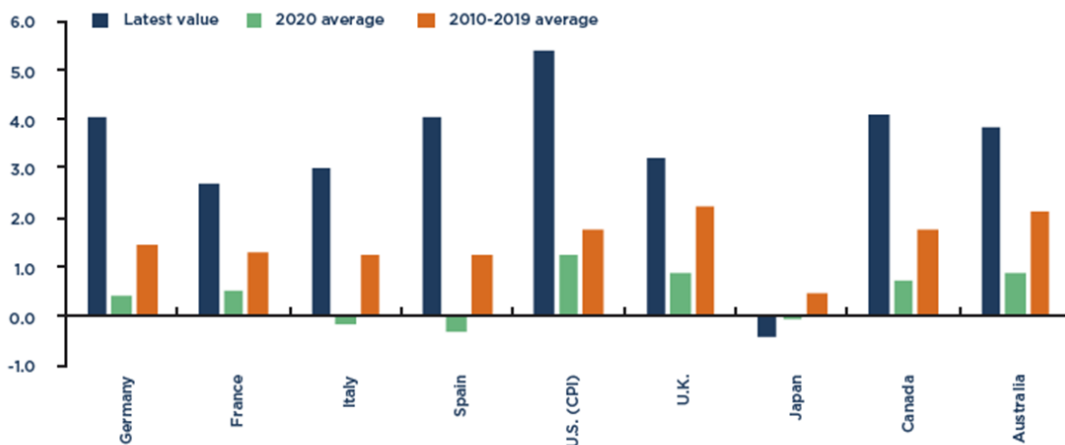
Evolution of some selected commodity prices, logarithm scale, base 100 = ave. 2019



Sources: LME, Refinitiv, SteelHome.

A peak in inflation in advanced economies, but risks are tilted to the upside. The inflation mystery could be complicated by reports of labour shortages. In the UK and the US, wage growth has picked up, as businesses offer higher compensations to fill job vacancies. In the UK, the government even had to give temporary visas to fuel tanker and food lorry drivers, as well as poultry workers, to address the issue. Although lorry driver shortage was already an issue before the pandemic in the UK, it has been exacerbated since the country formally left the European Union (EU). An increase in labour costs could mean more persistent inflationary pressures, i.e., inflation levels above the targets of major central banks.

Selected advanced economies: headline inflation rate, %YoY

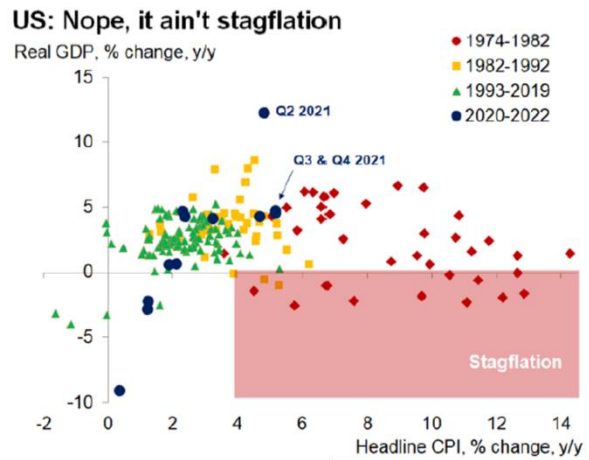


Source: National Statistics Office, Refinitiv Datastream.



In the debate between transitory and runaway inflation, we have repeatedly said that the truth lies somewhere in the middle, with inflation likely to be “sticky but not oppressive”.

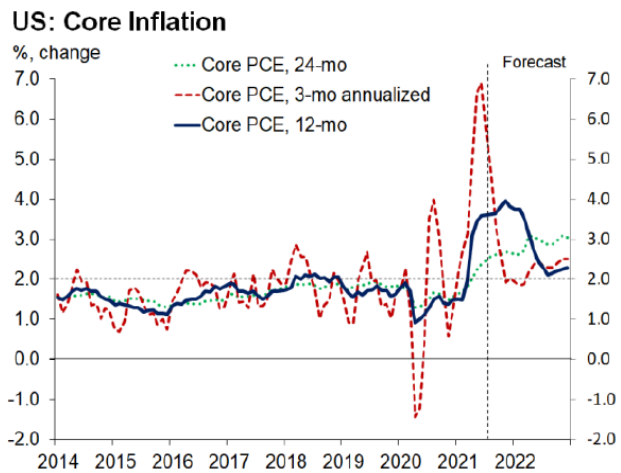
Still, with successive shocks affecting global supply chains and labor supply remaining constrained, many have been worrying about stagflation, fearing that we’re headed into an economy where inflation is rampant and the economy feeble. There’s no doubt that inflation is currently running much hotter than in the decade pre-COVID. But what’s missing in the discussion on stagflation is the “stag” part – stagnation. In the last episode of stagflation from late 1973 through 1975, headline CPI inflation averaged 11% but real GDP contracted 3.1%. Today, headline CPI inflation is running at 5.4%, but real GDP is expanding at a strong 4% clip.



Source: World Bank (WB) & International Monetary Fund (IMF)

Today’s inflation dynamics are best described as MESSI – Moderating Expansion with Sticky Supply-driven Inflation.

These dynamics aren’t only a reflection of supply constraints; nor are they only an indication of strong demand. Rather, they’re a combination of these two forces creating a messy inflation environment. Initially, extreme health conditions, severe social distancing measures, and unprecedented fiscal transfers to households supported a surge in spending on goods. With domestic and international supply struggling to rebound quickly and inventories being run down, prices for goods surged. Later, as the health situation improved, the re-opening of the economy led to greater demand for services which also ran into the tight supply conditions, leading to higher service sector inflation.



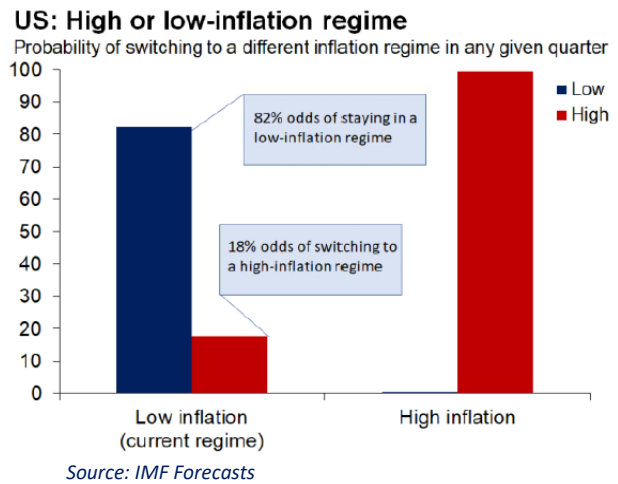
Sticky but transitory: Sticky inflation into 2022 with moderate risks to the upside.

According to Oxford Economics, the baseline view suggests persistently high inflation into the first half of 2022 with the recent rise in energy prices adding around 0.2 ppts to headline inflation. It is forecasted a personal consumption expenditure (PCE) inflation at 4.4% y/y in Q4-2021 and 2.1% in Q4-2022, and core PCE inflation at 3.8% in Q4-2021 and 2.3% y/y in Q4-2022. Combined, elevated resource utilization, lingering supply constraints, and higher commodities prices are an upside risk to inflation forecast. But, given the negative fiscal impulse in 2022, the gradual rebound in domestic and global production, and the expected gradual tightening of monetary policy, Oxford Economics thinks the risk is moderate. As of today, their Markov switching model shows an 18% chance of the US economy shifting



into a high-inflation regime (persistently above 5%) and here we should worry about inflation overshooting risk. While these odds are near their highest since the 1990s, Oxford Economics analysis indicates that such a regime shift generally requires a combination of factors that aren't present now.

In the 1940s, these factors included excessively loose monetary policy, the lingering effect of a 40%-dollar devaluation, expansionary fiscal policy, and the end of price controls after WWII. In the 1970s, they included the gradual politicization of the Fed, output gap mismeasurements, the end of the gold standard in 1971, and the oil price shocks. Today, structural factors continue to point to low inflation. In particular, higher savings and lower spending as the US population ages, ongoing technological advances, solid productivity growth post-pandemic, and sustained (though slower) globalization should keep a structural lid on price pressures.



40% of US dollars in existence were printed in the last 12 months

As part of the US government's effort to stimulate the economy, the US government issued stimulus checks to millions of employed Americans. Where did the money come from? The government had to borrow by selling its debt in the form of US Treasury bonds and other types of securities. The after the bonds are sold, the Federal Reserve gets to work and starts printing money. But money printing is not new. The Federal Reserve has been printing money to pay for about 29 trillion USD in US debt. However, what's new is that the 40% of US dollars in existence were printed in the last 12 months alone.

What is so ironic about this number is that just two years ago, Federal Reserve reported that 40% of Americans don't have 400 USD in the bank for emergency expenses, according to a report from ABC News. The 2019 Federal Reserve survey finds that almost 40% of American adults wouldn't be able to cover a 400 USD emergency with cash, savings, or a credit card charge that they could quickly pay off.

The US government has been printing massive amounts of new money. On January 6, 2020, the US Federal Reserve had around 4 trillion USD. On January 4, 2021, the number increased to 6.7 trillion USD. In addition, the US Congress passed an infrastructure bill that funds more than a trillion dollars in nationwide federal spending on Nov. 5, 2021. The bill is the largest investment in the nation's infrastructure in decades. Money is usually a medium of change to facilitate the sale, purchase, or trade of goods between buyers and sellers. However, since there is no productivity (good and services) to back up the trillions of dollars currently in circulation, printing more money doesn't necessarily increase the economic output (productivity), it only increases the amount of money circulating in the economy.

Such money creation may lead to a stagnation and worst-case scenario to a stagflation. It will cause overheated financial bubbles fueled by too much easy money in the system – a bubble that could burst with painful fallout. Creating too much money that chases too few goods also leads to price inflation, decreasing the purchasing power of the dollar. Additionally, we need to think about rate hikes as raising



costs for households and businesses that borrow money. But now, the **Fed itself is a major borrower**. It means that higher rates not only increase the amount of interest each year the US has to pay on its debt--which can squeeze out other spending--but may also have to fund the Fed. The Fed has gone from being a slight net lender to the US financial system in 2007, to a net borrower of almost 8.5 trillion USD. And it means the Fed itself has probably the single biggest exposure of any global financial player to the impact of rate hikes.

Fed uncertainty in the face of sticky inflation is more hawkish

While the Fed's new policy framework is more tolerant of inflation to generate a broad labor market recovery, Fed Chair Powell, Vice Chair Clarida and various other FOMC members have repeatedly stressed that if measures of inflation expectations move up in a way that is inconsistent with the Fed's inflation mandate, they will tighten monetary policy. Recent inflation readings, will reinforce tighter monetary policy by the Fed.

With the Fed having to consistently revise its inflation forecast up, policymakers' language has gradually moved from describing inflation as purely "transitory" to discussing how factors leading to persistent inflation are expected to "lessen" and "abate" – a delicate but notable shift. Tapering of bond purchases will started already last November 2021, the policymaking Federal Open Market Committee announced in its post-meeting statement. The process will see reductions of 15 billion USD each month where 10 billion USD in Treasuries and 5 billion USD in mortgage-backed securities compared to the current 120 billion USD a month that the Fed is buying. It is worth noting that the Fed's motivation for tapering is to slowly remove the monetary stimulus it has been providing the economy.

"Our baseline expectation is that supply chain bottlenecks and shortages will persist well into next year and elevated inflation as well," Fed Chairman Jerome Powell said. "As the pandemic subsides, supply chain bottlenecks will abate and growth will move up and as that happens inflation will decline from today's elevated levels." The statement also noted that the economy is expected to continue improving, particularly after the supply chain issues are resolved.

Yes, it's naïve to think that the Fed can unclog ports, boost semiconductors production, or free labor supply. But more hawkish monetary policy guidance will lead to a tightening of financial conditions via higher long-term rates, a stronger dollar and potentially lower stock prices. This should limit the pace of demand growth, and thereby constrain one of the prime inflation drivers as supply gradually ramps up.

In a matter of fact, it's worthy to mention that even if the current increases in prices that are due to supply chain disconnections fade away over time, annual inflation risks will stay elevated through 2022. The situation could worsen if policies do not prevent a build-up of inflation expectations. With its new mandate and a clear focus on maximum employment, the Federal Reserve is prepared to have a temporary (or, in the current jargon, transitory) over-shoot of inflation over its target, particularly as this comes after a prolonged period of undershooting. The risk is that a transitory over-shoot might develop into a prolonged one if inflation expectations become unhinged and wage-push inflation factors mount.



Higher inflation may be here to stay

It seems more likely that inflation may continue to overshoot target for some time. If inflation hits 5 % the Federal Reserve will need to step up its policy communications arguing that the increase in inflation is only transitory and convince households, companies, and financial markets that there will be a return to lower rates of monthly inflation soon. Its arguments will be bolstered if the current supply-chain disruption and global energy price rises end.

The timing of halting quantitative easing and then reversing it, then increasing policy interest rates is yet to be clarified by the Federal Reserve. For instance, an unanticipated policy reversal to guard against the loss of central bank credibility might result in a sudden financial market downturn and public sector balance sheet mismatches. Bond prices will be driven by how central banks respond to higher inflation, through a combination of ending quantitative easing and higher policy rates.

The Federal Reserve needs to prepare contingency plans for its actions if a 5 % inflation rate looks like it is becoming embedded, with inflation expectations rising. If, it raises its inflation projections again following its December meeting, it may need such contingency plans sooner rather than later. Our view is that given the uncertainties about the duration of higher inflation, wages, and an employment rate still below its pre-pandemic level, the Federal Reserve will be cautious in tightening policy, particularly as it will face a trade-off between stabilizing below-target employment or above-target inflation. Interest rates can be a bit of a blunt instrument. If they go up too far and too fast, that can choke off economic recovery and even cause a recession. Moving too far, too fast, could waste the best chance it will have to escape the trap of near deflation with interest rates at their lowest possible levels. If the cost of that is a period of moderately above-target inflation, they are likely to pay it.

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