Credit Research
Macro

2022 Credit Outlook: Inflation. Reversion to the mean

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Headline inflation is surging after years of dormancy. Longer-term expectations should remain anchored, but the re-emergence of new variants runs the risk of extending some supply constraints in the short-term

Summary

- After years of undershooting of inflation targets, particularly in developed markets, headline inflation is surging after years of dormancy. A number of countries are now experiencing headline inflation rates at multi-decade highs.
- Globally, inflation appears set to continue its climb higher in the near-term, as factors driving inflation have recently proven more persistent than initially expected. Many are due to problems in global supply chains, and those price rises should eventually reverse, particularly as demand shifts from the consumption of goods to services as local economies re-emerge from various lockdowns, but they could take longer to subside as is the general consensus. The re-emergence of COVID-19 outbreaks as well as new variants run the risk of both extending some supply constraints as well as creating new ones.
- Much attention has centered on the formation of supply bottlenecks in response to persistently strong demand for consumer goods. However, growth in headline inflation has also become increasingly broad-based, including food, energy, and shelter costs. Fiscal and monetary policies have undoubtedly contributed to higher levels of inflation--by design and somewhat by desire. Market-based inflation expectations have risen, but mostly for shorter time horizons. The prospect of tighter monetary policy in the near term appears to have reduced expectations for growth and inflation down the road.
- In Australia, we believe inflation will be more subdued relative to global peers. While wage growth should improve as employment creation strengthens on the back of very high vaccination rates, a gradual re-opening of international borders to resolve areas of heightened demand for labour should act to alleviate upward pressure on wages. We believe other factors that have strengthened headline inflation in the Northern Hemisphere--particularly energy prices and rents--are likely to be less pronounced locally.

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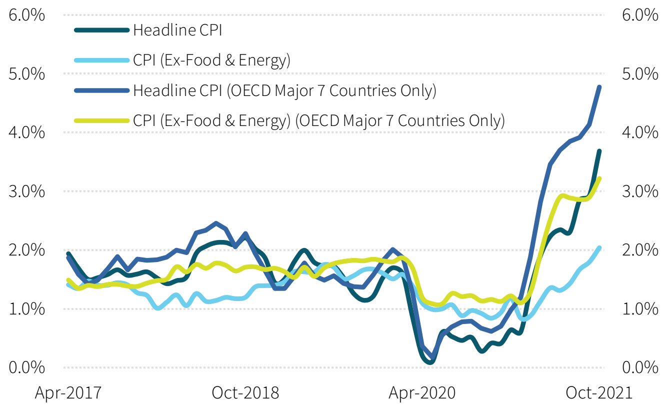
Inflation has further to run in the short-term, but supply-chain challenges may have peaked

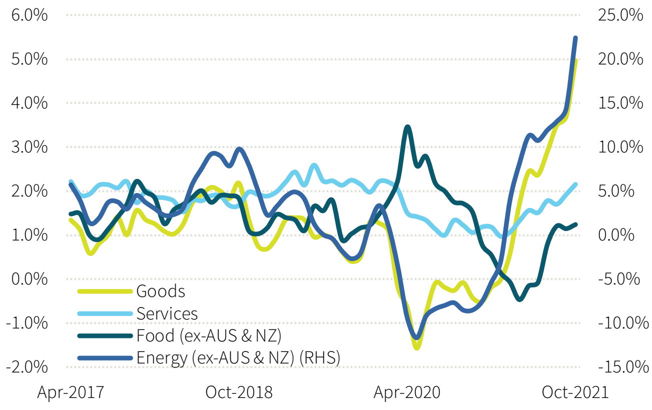
After years of undershooting of inflation targets, particularly in developed markets, headline inflation has surged after years of dormancy (see Figure 1). A number of countries are now experiencing headline inflation rates at multi-decade highs, although pandemic-induced consumption means that it remains predominantly concentrated in goods (see Figure 2). Disruptions in energy and commodity markets, which are forecast to persevere well into 2022 as they coincide with a hasty energy transition from traditional thermal baseload power sources that has not been aided by adverse weather (most notably in Europe), have too helped to push up prices and limit output, spilling over into a general shortage of broader goods.

Figure 1: Inflation amongst Advanced Economies



Source: OECD

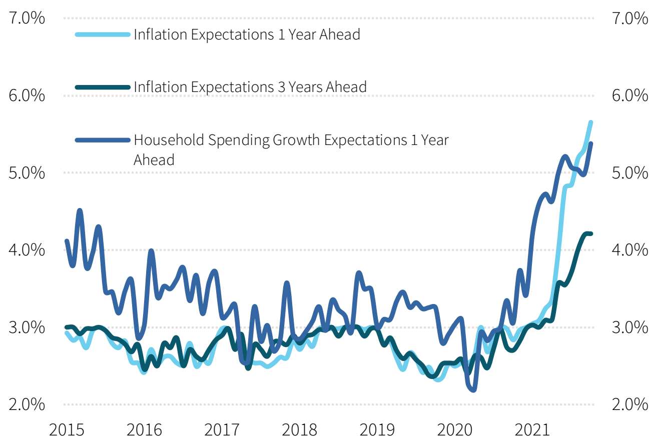
Figure 2: Breakdown of Inflation Drivers*



*Source: OECD *Advanced Economies*

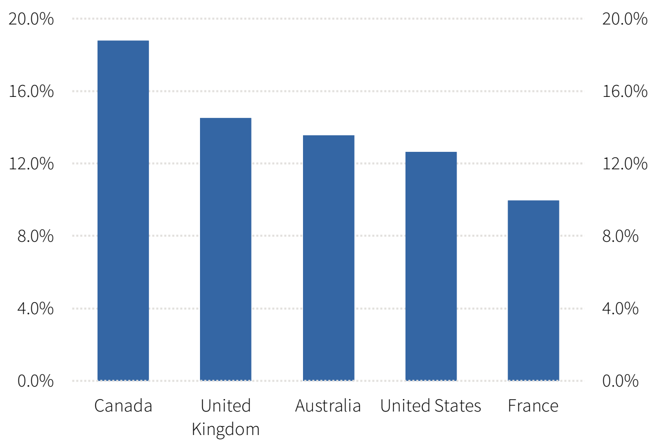
The United States remains the driving force of stronger inflation dynamics in advanced economies in the short term, although both headline and core (excluding food and energy) inflation amongst a broader set of advanced economies is too starting to approach or indeed exceed central bank targets (see Figure 1). Recovering demand alone is unlikely to result in sustained periods of future inflation, although these developments have occurred amid still-substantial monetary support, suggesting near-term risks are tilted to the upside (see Figure 3). The handoff from public to private sector demand through fiscal support has provided households with higher levels of savings relative to pre-pandemic levels (see Figure 4), some of which will be spent in the near-term as economies reopen.

Figure 3: US Consumer Expectations



Source: Nordea Markets, Federal Reserve Bank of New York

Figure 4: Excess household savings



Source: OECD. Excess savings is equal to the cumulative difference of the net household saving ratio over 2020Q1-2021Q2 from its average value in 2019.

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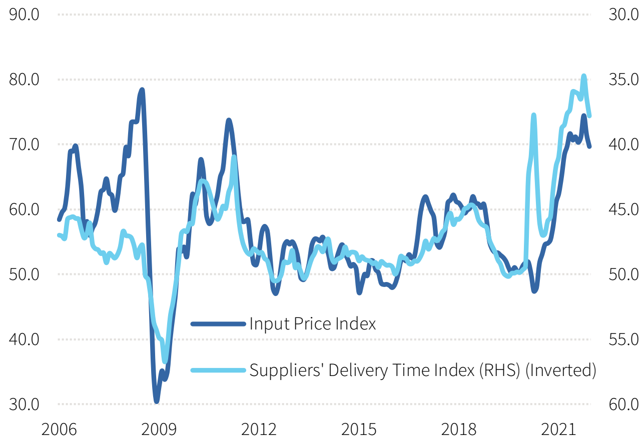
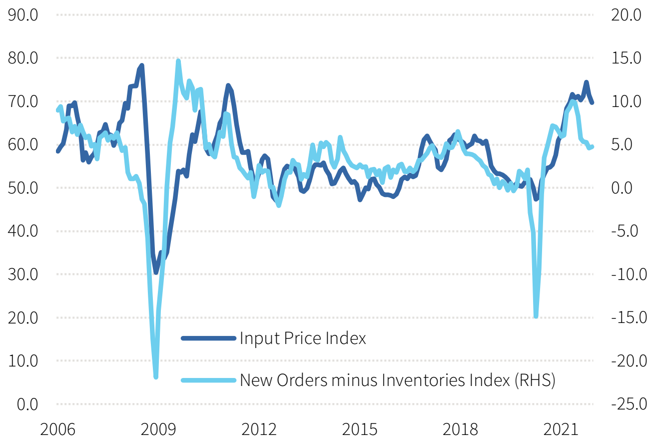
The broader narrative for current inflationary pressures has been well-chronicled: unprecedented fiscal and monetary support which transferred demand from the government to the household, magnified by a sharp shift in consumption from services to goods, resulting in rising commodity prices (input into the cost of manufacturing goods) and supply-chain bottlenecks and thus, upward pressure on headline inflation rates. In other words, too much money chasing too few goods, combining with a negative drag to productivity as the pandemic restricted movement of individuals to create a perfect storm. Input prices and supplier delivery times in some parts of the world have lengthened to the greatest extent on record (see Figure 5).

Figure 5: Manufacturing Input Prices and Delivery Times



Source: JPMorgan, FIIG Securities

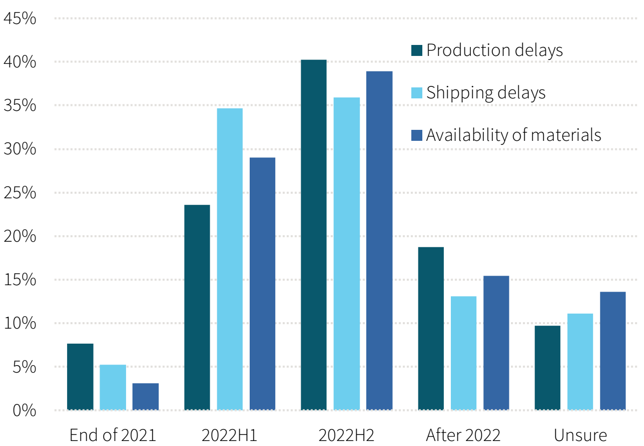
Figure 6: Manufacturing Backlogs and Input Prices



Source: JPMorgan, FIIG Securities

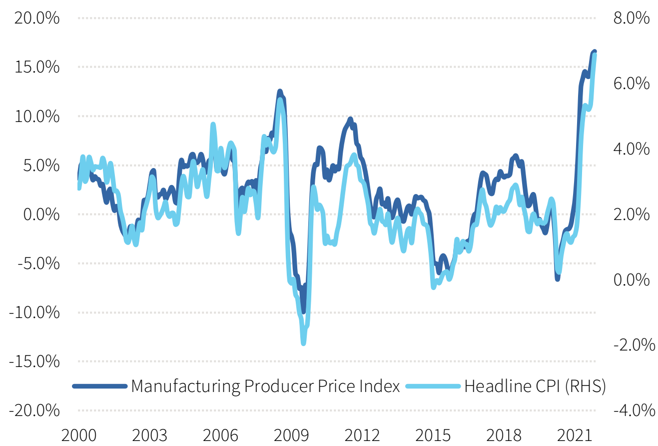
The unique nature of the current recovery has raised questions about how long supply will take to catch up with accelerating demand. Indicators of supply shortages have recently settled as there are signs that the backlog is starting to unwind (growth in new orders minus inventories; see Figure 6). While supply-chain challenges may have therefore peaked, participants in the supply chain do not expect disruptions to end until the latter half of 2022 (see Figure 7), which suggests upward pressure on prices still has some further to run (see Figure 8). The re-emergence of COVID-19 outbreaks as well as new variants run the risk of both extending some supply constraints as well as creating new ones, particularly as unnerving politicians re-impose restrictions on the movement of individuals as a first response. This added complexity could further prolong short-term inflationary pressures.

Figure 7: When Will Supply Chain Disruptions End?*



Source: The CFO Survey (Duke University and the Federal Reserve Banks of Richmond and Atlanta)
**% of US corporates surveyed*

Figure 8: US Manufacturing PPI and CPI



Source: Federal Reserve Bank of St. Louis, FIIG Securities

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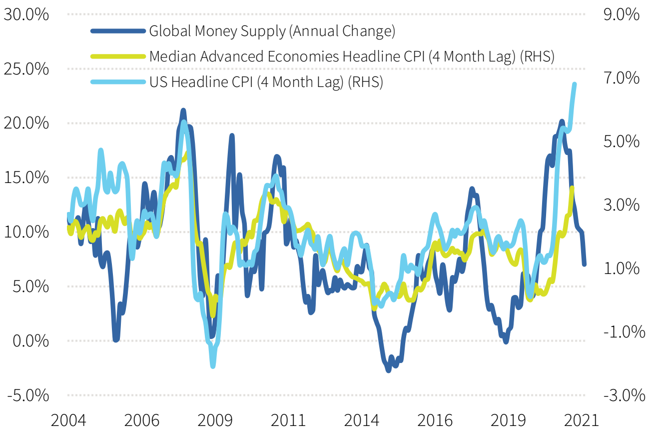
Longer-term expectations should remain anchored as the fiscal and monetary unwind commences and wage growth expectations remain modest

As factors driving inflation have recently proven more persistent than initially expected, attention has turned toward the demand-side; or more pointedly, the contribution from still-substantial monetary support. On balance, the current inflation narrative is almost certainly a function of both the forementioned supply shock as well as a demand shock, although the latter should come as little surprise given willingness from central banks' to let inflation exceed thresholds for a period of time in order for unemployment to fall and wages to rise.

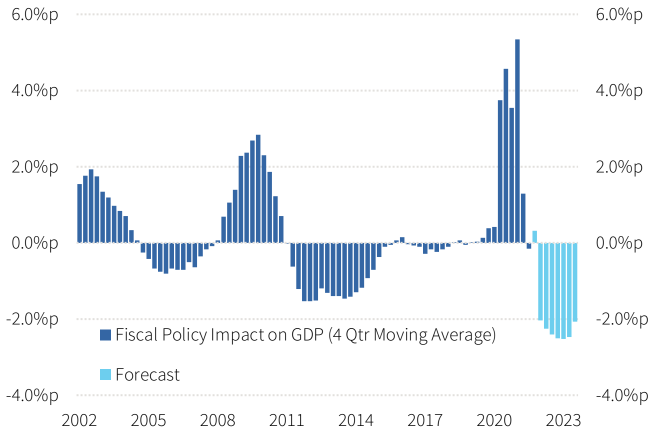
With an increasing number of developed countries embarking on a path of (relative) normalisation in interest rates, an inflection point should be reached at some point in 2022 when inflationary pressures from the increase in circulation of cheap money should start to subside (see Figure 9). By extension, fiscal support that propped up households and small business during the pandemic will fade from view (see Figure 10), which may condense the expected upside from well-resourced households.

Figure 9: Money Supply and Inflation



Source: Bloomberg, FIIG Securities

Figure 10: United States Fiscal Drag



Source: Brookings. As measured by the Hutchins Center Fiscal Impact Measure

Despite the sharp rise in short-term inflation, long-term inflation expectations have stayed relatively anchored so far (having recovered from the pandemic-lows in 2020), with little to suggest those expectations have become de-anchored (that is, outside of various central bank inflation targets) (see Figure 11 overleaf; breakeven inflation is a market indicator of the level of inflation over a period of time, equal to the difference between nominal and real yields).

The shape of the yield curve may also indicate a degree of central bank policy misstep (letting growth and inflation run too fast, for too long), as a more drawn out policy reaction should typically be supportive of an upward sloping yield curve. However, given the inseparable relationship between rates and the outlook for growth at present, achieving an upward trajectory in both real and nominal yields will be an incredibly delicate balancing act for central bank governors. As it stands, with fiscal support (tax breaks and other benefits) drawing to a conclusion and wage growth (explored below) failing thus far to keep pace with (increasingly more persistent) inflation, the prospect of tighter monetary policy in the near term appears to have reduced expectations for growth and inflation down the road as represented by spread between the 2-year and 10-year (see Figure 12 overleaf).

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Figure 11: US Long-Term Inflation Expectations

*Source: Bloomberg. *As measured by 5 Year 5 Year Forward Inflation Expectations*

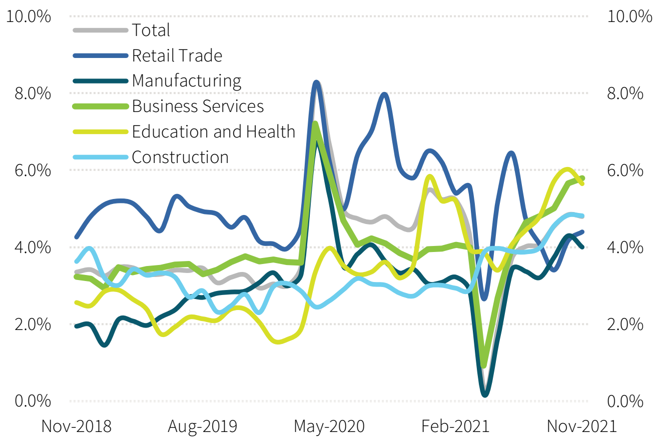
Figure 12: United States 10Yr-2Yr Spread (bps)

Source: Bloomberg

Headline (nominal) wages have indeed registered strong growth in recent months amongst some of the stronger performing advanced economies (including the fastest pace in the United States since the early 1980's), with sectors and countries most reliant on cross-border inflows into the labour force predictably putting upward pressure on wages (see Figure 13). As economies quickly approach full employment, wage pressures should build. However, higher inflation expectations amongst households over the next few years have so far failed to translate into noticeably higher wage expectations, which remain broadly similar to pre-pandemic levels (see Figure 14).

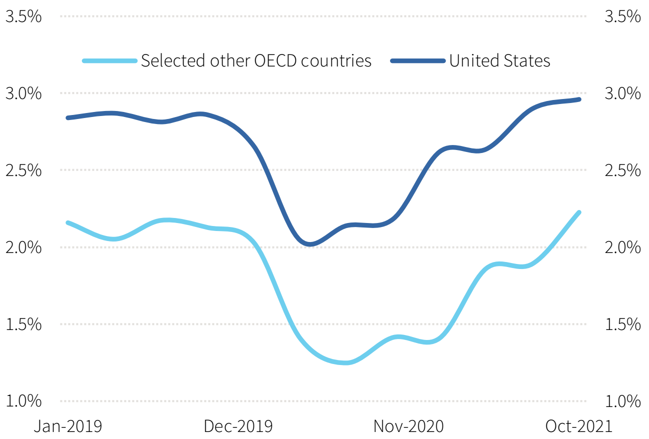
More broadly, while falling unemployment in the United States, for example, continues to push toward the point that officials consider "full employment" has been achieved (albeit, interestingly, above the 3.5% unemployment rate achieved pre-pandemic), which should therefore translate into firming inflation expectations, the labour-force participation rate remains well-below pre-pandemic levels, and for a variety of reasons--health concerns foremost amongst them. There therefore still appears to be a significant gap to be filled to recover to pre-pandemic levels, although it is very much conceivable that the supply of labour will never return to pre-pandemic levels.

Figure 13: United States Average Hourly Earnings by Industry



Source: Federal Reserve Bank of St. Louis

Figure 14: Year-ahead wage expectations



Source: OECD. Selected countries are Australia, Canada, New Zealand, Norway, Sweden and the United Kingdom.

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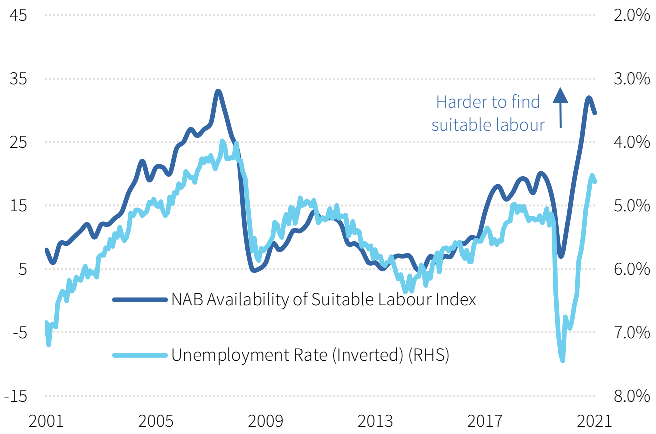
Higher inflation in Australia in 2022, but likely to remain relatively subdued compared with global peers despite a favourable backdrop for households.

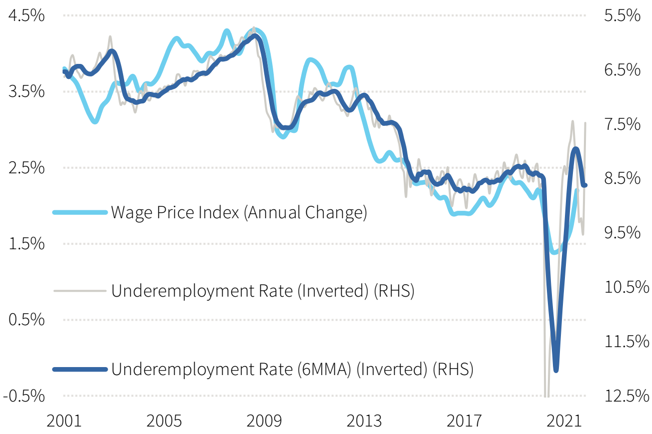
We expect higher inflation in Australia in 2022, although we believe some contributions to inflation are likely to remain relatively subdued compared with other advanced countries. Many of the factors that have caused inflation to rise elsewhere are also at play in Australia. On the back of very high vaccination rates, the backdrop for Australian households is favourable, with a particularly successful transfer from government to household underpinning a savings rate well-above historical averages, which should translate into a sustained period of above-average consumption. Continued tightening in the labour market (see Figure 15) will support stronger wage growth through 2022, particularly given that labour supply growth is still constrained by limited immigration, which is also helping to keep the participation rate elevated.

Figure 15: Unemployment Rate and Availability of Labour



Sources: Bloomberg, NAB, ABS, FIIG Securities

Figure 16: Wage Growth and Underemployment Rate



Sources: ABS, FIIG Securities

Australia's underemployment rate has been strongly correlated with wage growth over the last couple of decades (see Figure 16). The Reserve Bank of Australia has indicated the theoretical level of unemployment below which inflation would be expected to rise (and with it, stronger wage growth) may be less than 4%, or around a similar level to when we last witnessed decent wage growth. Even at these higher levels, wage growth is likely to remain relatively subdued compared with a number of advanced countries, although we note the higher starting point (minimum wage) locally, particularly amongst industries most likely to exhibit stronger wage growth (that is, those most reliant on cross-border inflows into the labour force). The recent reopening of borders for skilled workers (and students) in mid-December should also keep growth somewhat restrained.

Australia has also seen much less inflation in several major categories such as housing (rent), energy (utilities) (see Figure 17 and 18 overleaf), and food, which have not only contributed materially to higher inflation in many advanced countries, but also make up a significant portion of core inflation locally. Rents have been severely impacted by closed borders, particularly inner-city Melbourne and Sydney, while supply has been boosted by government incentives. Surging energy prices in a number of countries overseas, which partially reflect country- or continent-specific factors (particularly an overreliance on a particular source or provider, as well as coinciding with a transition toward renewable sources--which at times have proven insufficient), have not been replicated locally.

As a material producer and exporter of thermal coal and natural gas, Australian households are somewhat insulated from global energy price movements. While lower energy prices mainly reflected lower wholesale electricity prices, which is in part a result of increased capacity from renewable sources, the price of traditional baseload sources locally has not followed global prices materially higher.

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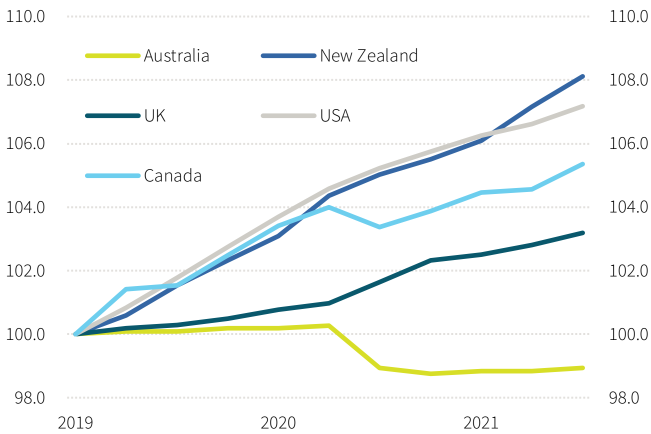
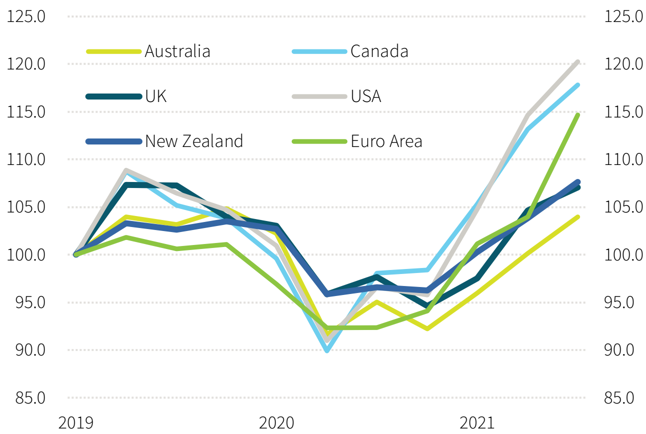
Figure 17: CPI – Rentals (1Q19 = 100)



Sources: OECD

Figure 18: CPI – Energy (1Q19 = 100)



Sources: OECD

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