

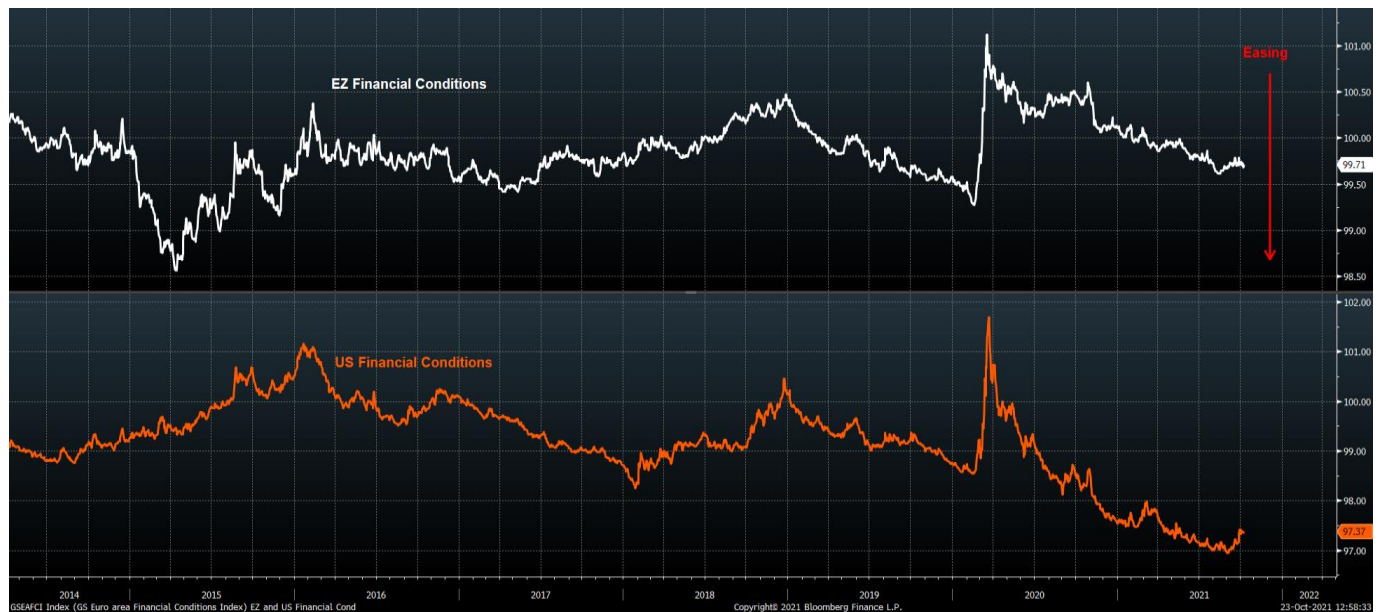
MI2 Chart Point: A Big Week in EZ Inflation

25th October 2021

Comment

Powell's speech on Friday was an important milestone in the global inflation narrative, a milestone that brought the Fed into line with some of its less prominent peers. With the risks now clearly tilted to the upside, no longer can inflation simply be dismissed as transitory. However, while a bout of honesty from JP is welcome, it does put further distance between the Fed and its larger central bank compatriots in the BoJ and ECB. In particular, despite the data, the ECB, especially Lagarde and Chief Economist Lane, continues to refuse to acknowledge reality. For example, at the end of last month in Sintra, we were told by Christine that we should "*not overreact to transitory supply shocks that have no bearing on the medium term.*" This advice reminded us of the scene in the Wizard of Oz when the Wizard tells Dorothy to "pay no attention to that man behind the curtain". This was the icing on the cake in a month where she had already taken policy spin to new highs by refusing to accept that reducing QE was, in fact, tapering! What a remarkable parallel reality we now inhabit!

In fairness, the EZ hasn't had the benefit of the vast US fiscal stimulus, and, on a relative basis, financial conditions aren't nearly as easy as they are on this side of the pond.



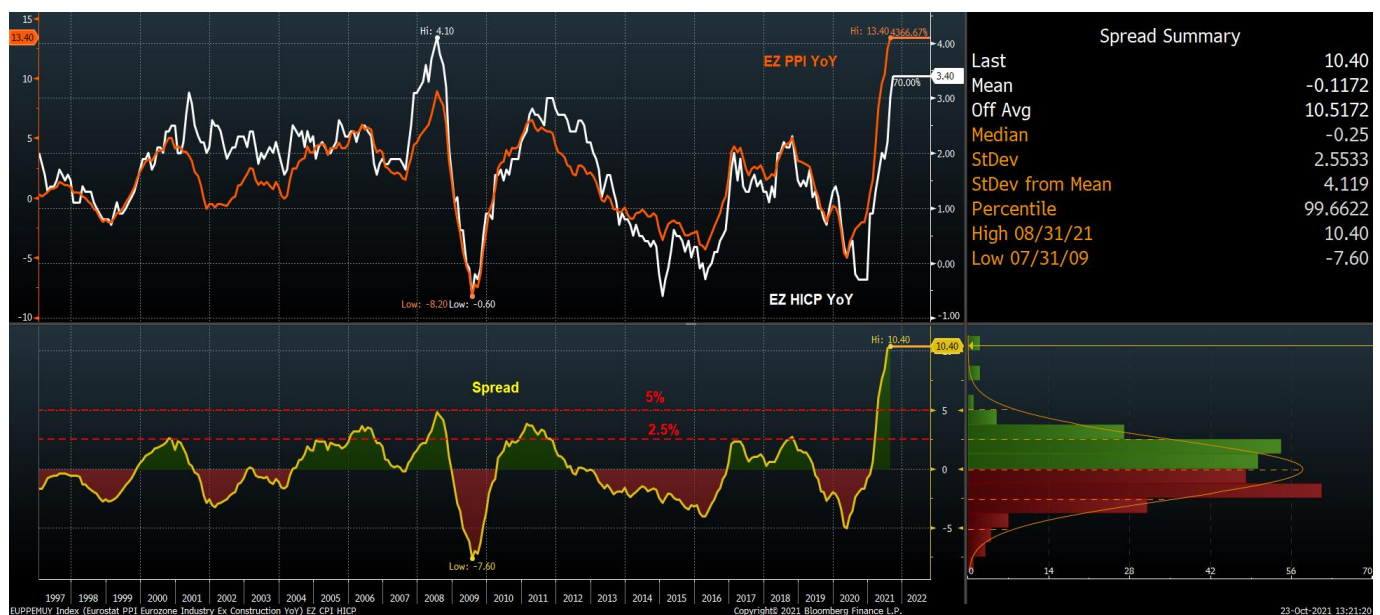
However, our immediate concern is inflation because we'll have a complete download of new PPI and preliminary CPI data tomorrow. Now, it's always hard to know precisely when numbers adjust, but over the next few prints, we don't believe that Europe can avoid the current global price tsunami ("US Stagflation or Inflation?" 12th Oct). By way of example, comments from last week's Markit PMI went straight to the point.

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"Shortages were once again seen as the key driver of higher prices in October, leading to a survey record increase in firms' input costs. Selling price inflation likewise accelerated as firms passed higher costs on to customers, reaching the fastest in almost two decades both in manufacturing and services."

It's this last point, about prices being passed on, that we believe markets and policymakers haven't fully appreciated. By overly supporting economies, officials have made consumer demand highly price inelastic! As a result, when it comes to absorbing costs or passing them on, companies can simply choose the latter ("Equities: A Glaring Dilemma" 27th Sept).

The problem is that even before the recent natural gas price surge, which won't show up until next month, Eurozone producer prices were up 13.4% YoY! If you think that is high, check out Sweden's PPI, which is 15.8%, a 45 year high! Anyway, the point is that this has created an unprecedented 10%, four standard deviation divergence to HICP. We don't believe this is sustainable, and if the spread reverts to a more normal 5%, or God help us 2.5%, we are looking at HICP between 8.5-11%! If the Teutonic hawks are already going parabolic at just over 3% headline inflation, what will they do if that number doubles or triples? No wonder BUBA's Weidmann quit early!



Thankfully, unlike policy officials, markets can't live in La-La Land, and they have started to price risk accordingly. However, if we are right about inflation, we are still in the early stages of the move. For example, our suggested short in Dec 2023 Euribor has sold off nicely ("MI2 Trader: Euribor Next (The Unreliable Girlfriend Trade)" 23rd Jun). However, it is still essentially priced for zero rates, and our target remains 99.50.

PS Even if you are a US investor and don't care about Europe, you can't ignore this risk. That's because, in fixed income, everything is at least partly fungible and a significant move lower in Euribor will make itself felt in the US front end.

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