December 12th, 2022

Inflation and Central Bank Watch

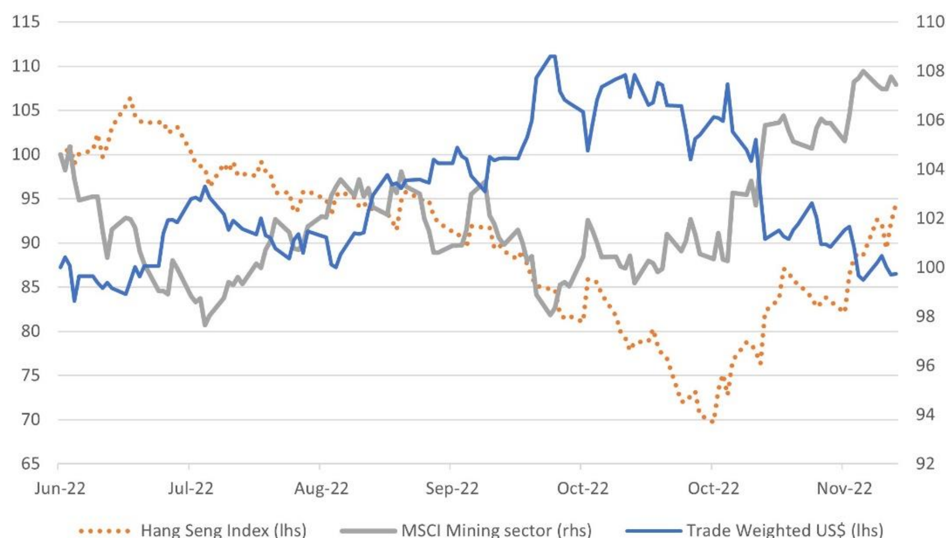
- **The Fed, ECB and UK MPC are all likely to raise rates by 50bps this coming week**
- **US producer price inflation showed surprising strength next up CPI**
- **US inflation trends likely exacerbated by recent weakness of the dollar**
- **The re-opening of China can only add to some of the global inflation pressures**
- **European equities look well set with less erratic behaviour from the ECB**
- **The drop in market volatility bodes well for a quiet end to the year**

Major global central banks are due to increase interest rates this week. On Wednesday, the Federal Reserve should raise interest rates by 50 basis points matching market expectations (of dialled down rate increases). The European Central Bank and the UK Monetary Policy Committee should also increase rates by 50bps each, capping a year that saw significant monetary tightening.

While the frequency and the magnitude of the rate increases is moderating, central bankers remain hopeful that these measures will eventually help curb inflationary pressures. A US inflation data report released last week surprised the market, registering a 6.2% year-on-year surge in producer price inflation, ahead of market expectations for an increase of 5.9%; the number for previous month was also revised up to 6.8% from 6.7%. The consumer price inflation report, due out Tuesday, should show a moderation in inflation to the market's estimate of 7.3%, down from 7.7%. Core price inflation, excluding food and energy, should also drop to 6.1% from 6.3%.

We are concerned that US inflation could prove sticky to the upside. In the past six weeks, the dollar has fallen sharply – approximately 10% – on a trade-weighted basis. A weaker dollar will amplify the inflationary pressures over the next few months. Also, at a global level, China's more relaxed stance towards COVID-related containment measures will likely increase the demand for commodities, adding another source to inflationary pressures.

Chart 1: China's reopening should put some upward pressure on inflation



Source: Bloomberg

The rise in the Hang Seng index over the past month could be a good proxy – or an indicator – of China's likely more robust growth in the coming quarters. The improved sentiment in China is also reflected in the sharp uptick in the mining sector's performance. A more robust Chinese economy is usually accompanied by some upward pressure on commodity prices. The recent drop in the dollar's value has reversed some previous gains that helped mitigate some of the inflationary pressures for US companies.

This week's US inflation data is expected to show an ongoing moderation in consumer prices at the headline level. However, some aspects of inflation, such as housing and transport costs, remain sticky. By contrast, energy and food prices have both moderated in recent months. We, however, remain concerned about the still-high wage inflation reported in the last labour market report. Last week's US productivity report showed that the higher wages are not translating into productivity growth, which, we believe, will be a source of pressure on corporate profit margins.

Despite what is likely to be a 50bps increase in ECB rates, the mood in the European markets remains relatively upbeat. Economists have turned to raising their EU growth forecasts of late. ECB officials appear much more in control of policy compared with the volatility we saw earlier in the year. Economists expect the ECB to forecast that inflation will be back on target by 2025 and that they can shrink the ECB’s balance sheet by the first half of 2023.

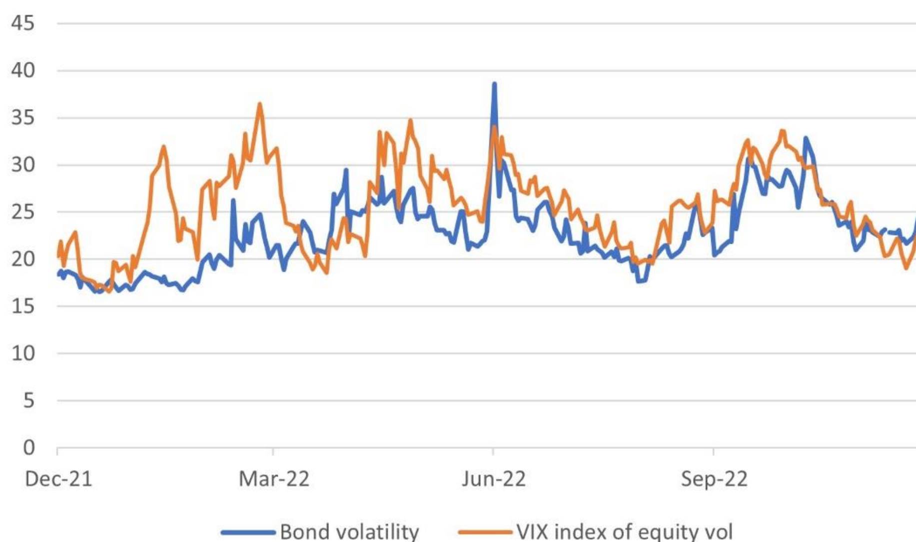
The calmness at the ECB and the more consistent performance of the euro have helped the European equity markets rebound sharply in the year's second half. Indeed, the recovery in the European markets has helped them outperform the MSCI World Index in dollar terms since the start of the year. If the recent rise in the euro is maintained it should deflate some of the inflationary pressures and leave ECB policy predictable and not too challenging for either the bond or equity market.

Chart 2: European equities outperform global equities year-to-date

Source: Bloomberg

In any case, greater predictability in the markets has led to less volatility in bond and equities markets and an air of calmness in these later stages of the year. However, the second half of the year has had its moments of unpredictability and exuberance; but it's nothing like the angst the year's first half experienced. Volatility has eased somewhat giving markets some room to reflect. Without a spike in inflation or any additional geopolitical challenges, we could be ending the year on a positive note. In the bond market, less volatility typically encourages a switch back to higher-risk bonds. Both high-yield and emerging market debt have performed satisfactorily over the past three months accumulating modest returns.

Chart 3: Volatility in bond and equity market eases, encouraging risk-taking



Source: Bloomberg

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