November 15th, 2021

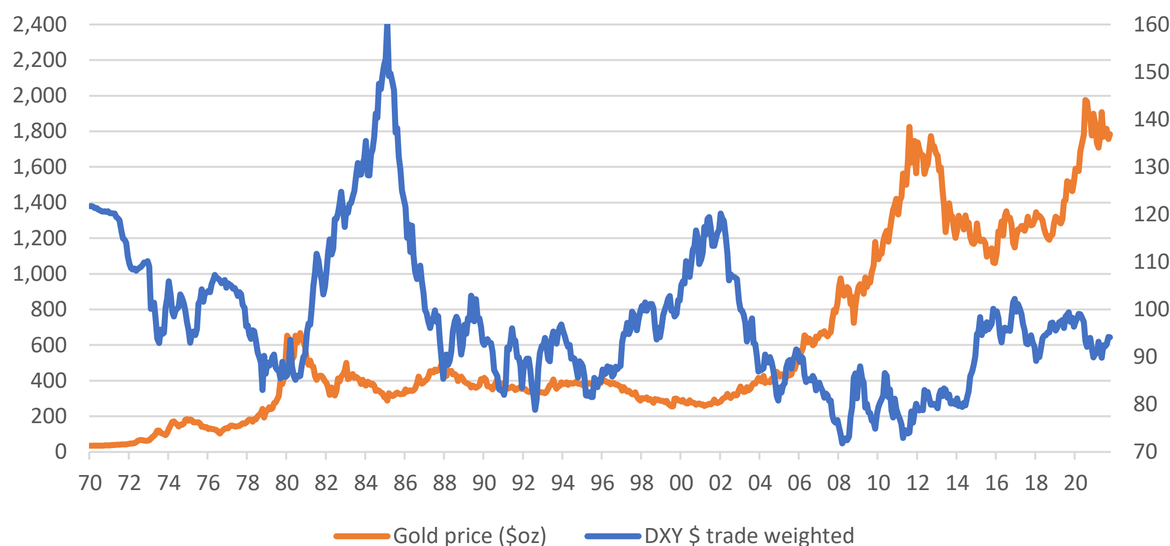
Inflation Alert – Fed Behind the Curve

- **We have an inflation problem at hand and central bankers just can't wish it away**
- **Easing supply bottlenecks and consumers forcing companies to cut prices could save the day for the Fed**
- **Notwithstanding the positive backdrop of an easy monetary policy, a violent sell-off in financial markets could ensue if the Fed leaves conditions too easy for too long**
- **We recommend rebalancing to commodity plays and markets left behind such as the UK and Japan**

After two decades of falling inflation, it is now quite understandable that central bankers are reluctant to acknowledge that we may have an inflation problem at hand. However, these are the same central bankers who negotiated the previous inflation challenge so 'well' that they had to spend the last 15 years trying to re-create it. Now that they have re-created the inflation they so desperately wanted, it appears to have all the hallmarks of a monster they may not be able to control easily.

Last week's US inflation data served as a wake-up call to those who still believe inflation to be transitory. Earlier this year, economists forecast that US inflation would peak somewhere below 4.0% and then slip back to under 2.0%. That was not to happen. Last week, US inflation was reported at 6.2% against the market expectations of 5.8%. Inflation pressures were seen across a broad set of both products and services and at the aggregate and core levels. Of note was the pick-up in what is called owners' equivalent rent. To date, this measure of inflation had dismally trailed anecdotal evidence of significant rent increases going through the system. Economists are suggesting that rents, which account for around 30% of the inflation basket, could add one percentage point more than their average contribution to inflation in the coming months.

Chart 1: US Inflation risk accelerates



Source: Bloomberg

The longer the central bankers stay in denial that inflation could persist well through their targets, the greater the probability that they will have to implement policies that will pop the myriad of bubbles in financial markets – the same bubbles they have been complicit in creating.

Many countervailing opinions are emerging in the market, which only shows the potential volatility and risks inherent in the current situation. James Knightley at ING suggests that **US inflation could hit 7%** in the coming months. On the other hand, Andrew Balls, PIMCO's chief investment officer, insists the spike in inflation will prove transitory; however, what else can one expect from the CIO of a major bond house to say? We, however, prefer to side with Mohamed El-Erian, PIMCO's former CIO, who called the Fed out for its hesitancy, terming it "a material risk to economic and social wellbeing". Indeed, he believes the Fed is making things far worse by maintaining its record easy monetary conditions. "The more the Fed falls behind (in tightening monetary policy), the greater the threat of it being a driver of three of four simultaneous contractionary forces in the middle of next year if not earlier; higher interest rates, financial market instability, a reduction in the real value of household savings and the erosion of fiscal stimulus."

Meanwhile, the financial markets have a positive backdrop of some of the easiest monetary conditions on record. **A world of zero interest rates and 6.2% inflation is inconceivable** unless the Fed sincerely and with a very high degree of confidence expects inflation to fall sharply in the coming months. We just don't see it. In fact, to the contrary, pipeline product and service sector inflation combined with signs of wage inflation do not presage lower inflation in the coming quarters.

Quite frankly, at this point, the Fed simply appears to be not in control. We worry that the Fed is taking an unacceptable and uncalculated risk with financial stability. Nevertheless, they have a few measures at their disposal to potentially take control of the situation in the coming few months. An acceleration in tapering and an indication that they will likely raise rates soon would allow them to regain control.

Late last week, before the CPI data release, we listened in to a conversation with former Fed Chair Ben Bernanke at an online conference from PIMCO. Bernanke generally espouses the party line of Fed monetary policy, although with a bit more freedom these days. He expects the Fed to taper bond purchases in line with the central bank's recent comments and sees the first rate increase in the first quarter of 2023. The argument runs that the Fed prefers to leave a six-to-seven-month gap between the end of bond purchase tapering and the start of interest rate increases. The idea is that the Fed doesn't want the market to see bond purchases as an extension of the policy interest rate changes. One has to

hope that the Fed understands the gravity of where the economy and financial markets find themselves. It would almost be inconceivable, if not downright irresponsible, for the Fed to leave the first increase in interest rates until the first quarter of 2023.

What might save the day for the Fed? Firstly, we would need supply constraints to start to melt away; secondly, a buyers' strike amongst consumers as they baulk at the higher prices, forcing companies to cut prices again and absorbing the cost pressures in their profit margins. But ultimately, the Fed's dialogue with the market has to play catch up with where the economy is today and the genuine inflation threat.

The pressure for a rate increase is evident from the US bond market re-pricing the implied level of inflation 21bps higher on the week at 3.11%, the highest implied inflation in history going back to 2002. The market prices 2.5 Fed rate increases by the end of 2022. There is a noticeable gap in credibility opening up for the Fed with the market seeing the need for a number of rate increases next year and the risk that the US will see the persistence of the highest inflation in decades.

We believe the key indicator of the Fed's credibility is the dollar. Last week, the USD trade-weighted index was marginally stronger on the week (+0.4%). However, alternative investments such as gold (2.5%) and bitcoin (6.0%) were higher in trading over the weekend.

Valuations have never been a good guide to the future performance of equity markets. However, if an investor puts a dollar into the US equity market this week, they will be investing at a Shiller P/E multiple of 40, last seen in 1999. A Bear Market Probability model used by Goldman Sachs has risen to one of the highest levels in 50 years with a probability of 90%.

As we noted last week, the great bull market in bonds and equities can only continue while the Fed maintains the very loose monetary policy. Last week's inflation news puts the days of plentiful liquidity at risk. Unless the Fed is more aggressive in its tightening intentions, it risks leaving it too late and having to act more aggressively later in 2022, threatening a more violent sell-off in risk assets.

Our advice is to be a more cautious investor, rebalancing to better value equities (commodity plays and markets left behind such as the UK and Japan). In bond markets, we have maintained short duration and look to take profits in high yield.

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