AFS

# Morning Comment

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## AFS Insights

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## Headline Sweep

- Pelosi Delays Infrastructure Vote as Democratic Rift Persists
- Manchin Wants Biden Social Spending Plan Cut to $1.5 Trillion
- Denmark Cuts Key Rate to Minus 0.6% to Defend Currency Peg

### On the ECB 'pulling a third Trichet'

- **A casual glance at FinTwit ('finance Twitter') and run-of-the-mill quotes in Reuters/Bloomberg wire articles show that the inflation spike is certainly aggravating lots of folks in markets.** But what about our central bank overlords in Frankfurt? Are they starting to lose their nerve over inflation? It goes without saying that ECB-speakers have been caught by surprise by the rather vigorous upswing in prices. ECB staff had forecasted a much more benign rebound in inflation.[1] Thus, the ECB's top brass is on the defensive in the sense that they must hedge their bets when they say that the inflation bounce will end up being transitory. The hedge here is that the ECB will tighten when inflation is becoming entrenched. Or "second round effects" in ECB-speak. For the uninitiated, second round effects are an increase in the general price level – so, not just a select number of goods and services – leading to wage gains that not just exceed inflation, but inflation plus productivity growth. Which in turn forces businesses to raise prices in response.
- **The ECB's fear of so-called round effects is… dare we say problematic (to use a word that we really dislike).** Eurozone real household income has been forced down last decade by demand depression policies: a feat and not a bug of the post-crisis response of the periphery following Germany's lead to live below its means. Wage earners – read: most households – could claw back some of the lost ground if rising real wages result in an increase in the household share of GDP.  But no, the ECB will call it quits if wages respond to the inflationary spike.
- **But back to ECB-speak.** At this week's ECB central bank forum several hawkish leaning members hit the mic. These include the heads of the Irish and Slovakian central banks. According to the wires, this is what they had to say. Here's Makhlouf:

[1] There are also Governing Council forecasts besides the staff forecasts. The former are secret, while the latter the ECB publishes on a quarterly basis.

*"We must be very vigilant of the risks out there," the governor of the Irish central bank said in a Bloomberg TV interview. Price pressures observed at the moment are largely transitory, he added. "Right now I don't believe there's a risk of excessive inflation," he said.*

- **Very vigilant.** That's almost like former President Trichet giving the all clear for a rate hike by saying the (in)famous words "strong vigilance" on inflation. Makhlouf is clearly in the inflation worrier camp. As is his Slovakian colleague Kazimir:

  *"If inflation remains elevated next year because of supply bottlenecks, my concern is that it could spill into wage negotiations for the following year as well," he said. But "we are not seeing this happening in key countries so far."*

- **But the doves want nothing of this inflation fear mongering. Here's President Lagarde according to Bloomberg:**

  *There are "no signs that this increase in inflation is becoming broad-based across the economy," Lagarde said at an ECB conference Tuesday. "The key challenge is to ensure that we do not overreact to transitory supply shocks that have no bearing on the medium term."*

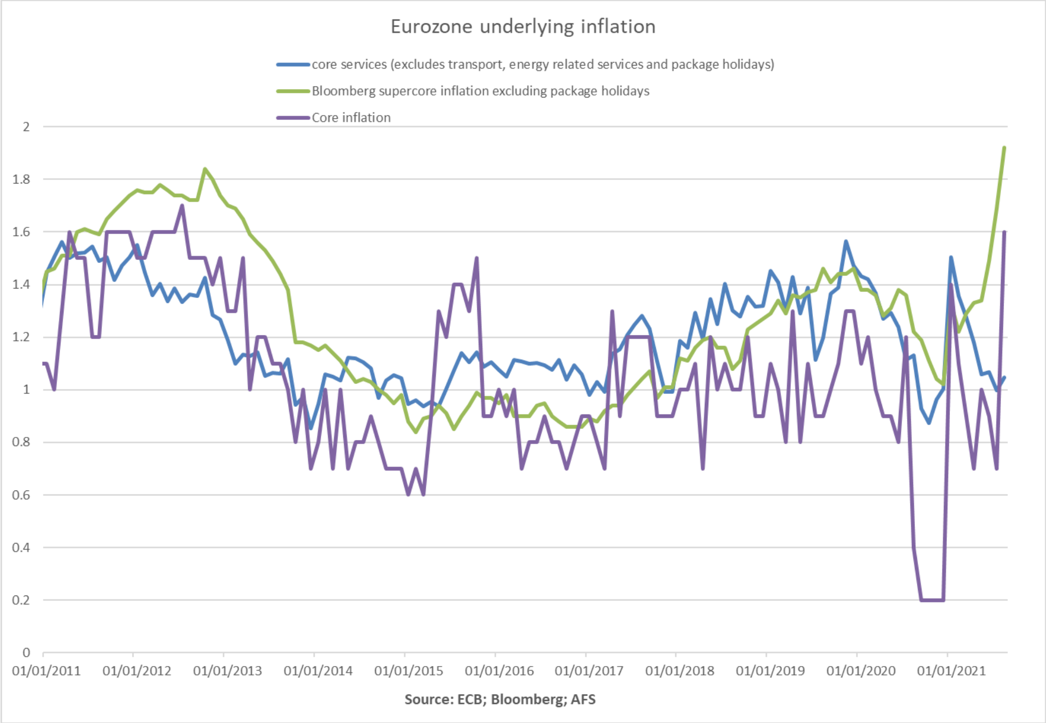
- **The French central bank head Villeroy de Galhau, who we consider a bellweather, is even more confident on the nature of the inflationary bounce**. According to Bloomberg he said that he had:

  *"no doubt" that inflation will be below 2% in 2023 and this "justifies therefore keeping accommodative monetary policy."*

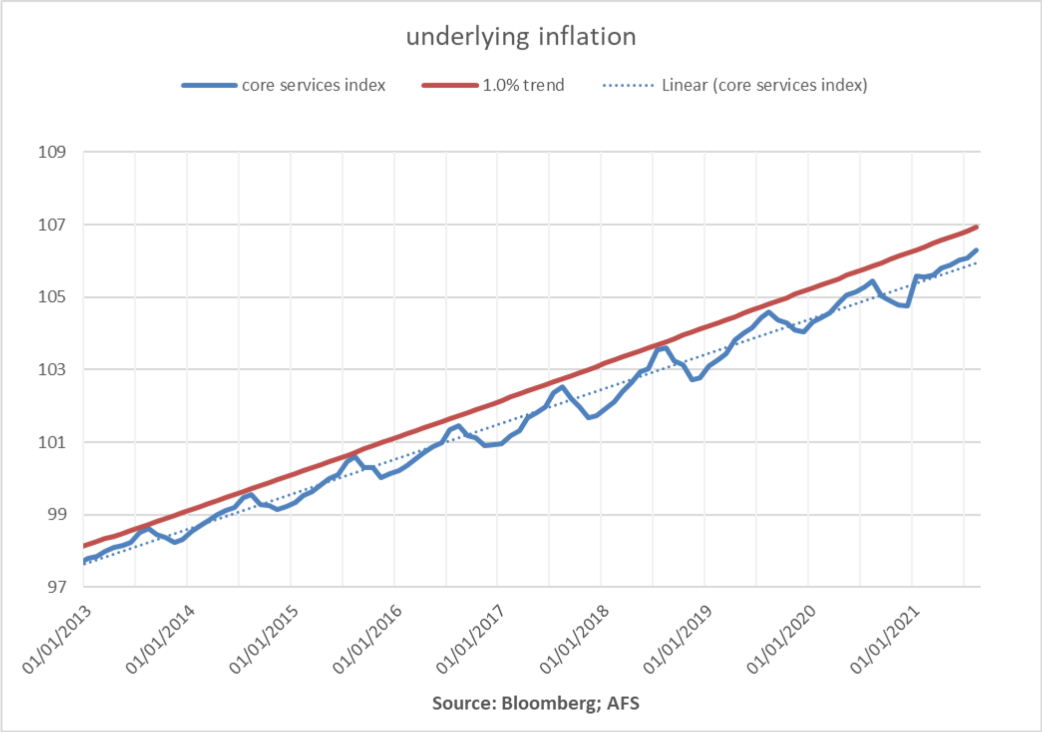
- **At least one Governing Council member, Portuguese central bank head Centeno, is trying to kill off the inflation discussion entirely by comparing the *inflationistas* to the ECB under former President Trichet, who was – on the surface – confronted with a similar inflationary spike:**

  *"We were fooled by some news on inflation in the past, which prompted us to act in the wrong way, so we don't want, definitely, to commit the same sort of errors this time," CNBC cites Centeno as saying*

  Centeno sees the inflation bounce as a supply shock. And if the ECB were to tighten policy in response, it will all end in tears.
- **But what about inflation. Is inflation really becoming 'unanchored', as central bankers like to say?** The chart below shows three measures of core inflation. Headline core inflation; the Bloomberg 'supercore' index of core inflation that includes only items that are responsive to the output gap; and our own measure of services price inflation, which excludes energy and transport related services. Each measure is designed to capture the underlying price trend and ignore the volatile energy and food prices.

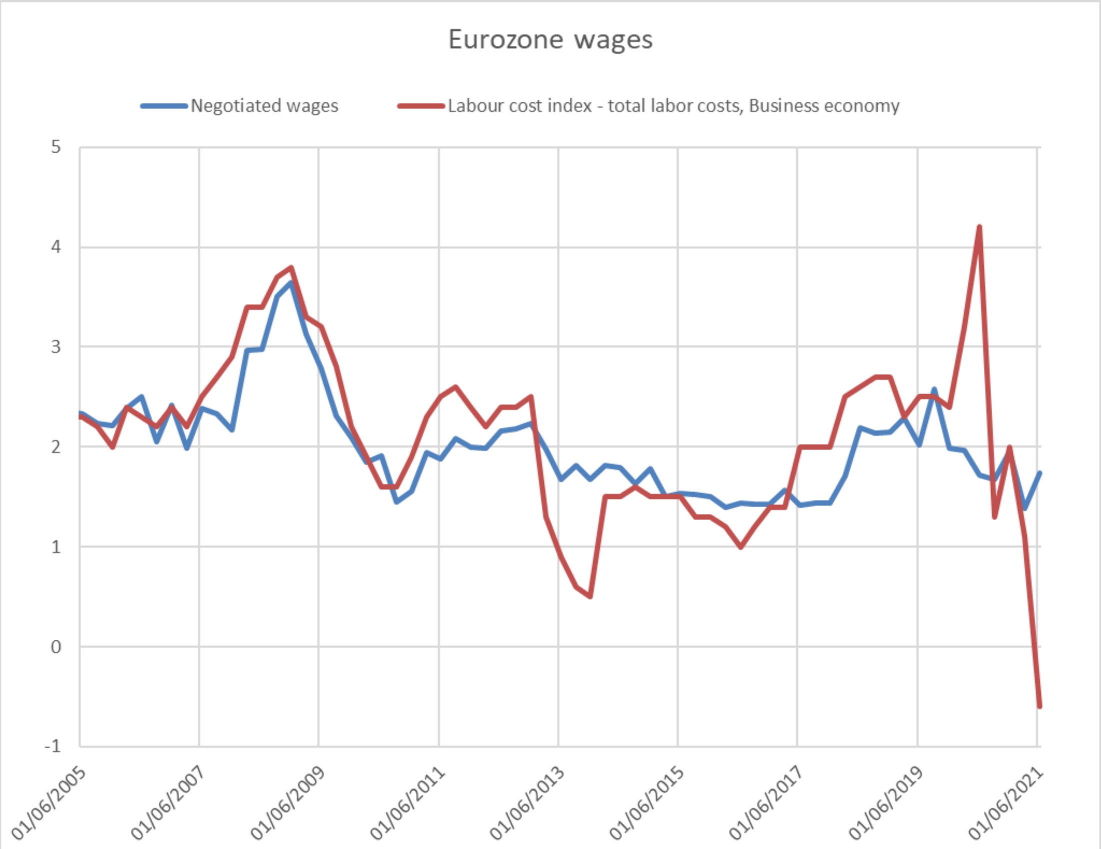



- **Notice the increase volatility in headline core inflation because of base effects. The pandemic artificially depressed inflation readings.** Now the opposite happens. The rise in 'supercore' inflation is quite stellar and is even surpassing the inflationary boom of early last decade. Services prices, which are supposed to be the stickiest, aren't showing a clear upward trend yet.
- **Since the pandemic has distorted the usual seasonal trends in inflation, it's best to look at the price index itself instead of the annual percentage change.** Charted below is our core services index:



There's nothing to see here, especially when one takes into account that during the period of 'normal' 2% inflation in the first decade of the euro (2000-2008) services prices rose at a stable annual trend pace of 2%.

- **What about wage growth?** Unfortunately, the pandemic has made a mess of most time series of wages. Two measures, wages negotiated through collective bargaining and unit labor costs are still normal. Both tell a story of contained price pressures:



Source: Bloomberg; ECB; AFS

Unit labor costs show the usual pattern around the recession, namely that productivity tends to rise strongly when the economy exits the recession. In turn, that results in falling unit labor costs. Negotiated wages are rising at a disinflationary pace when one takes rising productivity into account.

- **The bottom line is that inflation is a story of energy/food prices and goods prices (i.e. supercore inflation).** The increase in the former is exogenous and should be ignored by the ECB. Rising goods prices can be attributed to well-known supply chain problems. Having said that, while the energy price shocks of 2008 and 2010-2011 ended up being deflationary, that wasn't the case in the 1970s. Furthermore, if supply chains are 'brought home' instead of being mostly located in low cost/low wage producers, the disinflationary effect of globalization could go into reverse. In any case, there's no reason for the ECB to lose its nerve over inflation now. Expect Lagarde & Co to continue to explain away stronger price rises as transitory.
- **Translated to policy: expect the central bank to continue with QE after March 2022, when pandemic QE is set to end**. Before the inflationary shock crystalized

the ECB and the market were almost in unison that the purchase pace of the 'old' QE program would be bumped up from 20 billion euros a month by 10 or 20 billion euros a month. However, the increase in purchase volumes is no longer a done deal as we're clearly moving away from the disinflationary environment of the last business cycle that ended abruptly with Covid.

- **After March 2022, expect the ECB to keep buying bonds at the monthly pace of 20 billion euros a month indefinitely or until the ECB's inflation test is met**. If the ECB would remove the guidance of indefinite buying under the pretext of the inflation test and instead taper bond purchases to zero by the end of 2022 under whatever pretext the ECB would concoct, that would truly be a hawkish outcome. The ECB winding down bond buying completely over the course of 2022 would set the stage for a rate hike in the first half of 2023.

## Calendar

| TIME | REGION | EVENT | PERIOD | CONSENSUS | PRIOR |
|---|---|---|---|---|---|
| 01:30 | Japan | Jobless Rate | Aug | 2.90% | 2.80% |
| 01:50 | Japan | Tankan Large Mfg Index | 3Q | 13 | 14 |
| 01:50 | Japan | Tankan Large Non-Mfg Index | 3Q | 0 | 1 |
| 01:50 | Japan | Tankan Large Mfg Outlook | 3Q | 14 | 13 |
| 01:50 | Japan | Tankan Large Non-Mfg Outlook | 3Q | 5 | 3 |
| 09:00 | Netherl. | NEVI Manufacturing PMI | Sep | -- | 65.8 |
| 09:15 | Spain | Markit Manufacturing PMI | Sep | 58.2 | 59.5 |
| 09:45 | Italy | Markit Manufacturing PMI | Sep | 59.5 | 60.9 |
| 09:50 | France | Markit Manufacturing PMI | Sep F | 55.2 | 55.2 |
| 09:55 | Germany | Markit/BME Manufacturing PMI | Sep F | 58.5 | 58.5 |
| 10:00 | Greece | Markit Manufacturing PMI | Sep | -- | 59.3 |
| 10:00 | Eurozone | Markit Manufacturing PMI | Sep F | 58.7 | 58.7 |
| 10:30 | UK | Markit PMI Manufacturing SA | Sep F | 56.3 | 56.3 |
| 11:00 | Eurozone | CPI Core YoY | Sep P | 1.90% | 1.60% |
| 11:00 | Eurozone | CPI MoM | Sep P | 0.50% | 0.40% |
| 11:00 | Eurozone | CPI Estimate YoY | Sep | 3.30% | 3.00% |
| 14:30 | US | Personal Income | Aug | 0.20% | 1.10% |
| 14:30 | US | Personal Spending | Aug | 0.70% | 0.30% |
| 14:30 | US | Real Personal Spending | Aug | -- | -0.10% |
| 14:30 | US | PCE Deflator MoM | Aug | 0.30% | 0.40% |
| 14:30 | US | PCE Deflator YoY | Aug | -- | 4.20% |
| 14:30 | US | PCE Core Deflator MoM | Aug | 0.20% | 0.30% |
| 14:30 | US | PCE Core Deflator YoY | Aug | 3.60% | 3.60% |
| 15:45 | US | Markit US Manufacturing PMI | Sep F | -- | 60.5 |
| 16:00 | US | University of Michigan Consumer Sentiment | Sep F | 71 | 71 |
| 16:00 | US | Construction Spending MoM | Aug | 0.30% | 0.30% |
| 16:00 | US | ISM Manufacturing PMI | Sep | 59.5 | 59.9 |
| 17:00 | | Fed's Harker Discusses the Economic Outlook | | | |
| 17:30 | | ECB's Schnabel Speaks at Fed Conference | | | |
| 19:00 | | Fed's Mester Discusses Inflation and Employment | | | |
| | | France Sovereign Debt to be rated by S&P | | | |
| | | S&P Reviews Oman Rating | | | |
| | | S&P Reviews Poland Rating | | | |
| | | Moody's Reviews Bulgaria Rating | | | |

**Consensus data: Bloomberg News; All Times Are in Central European Time**