ALPHA SOURCES

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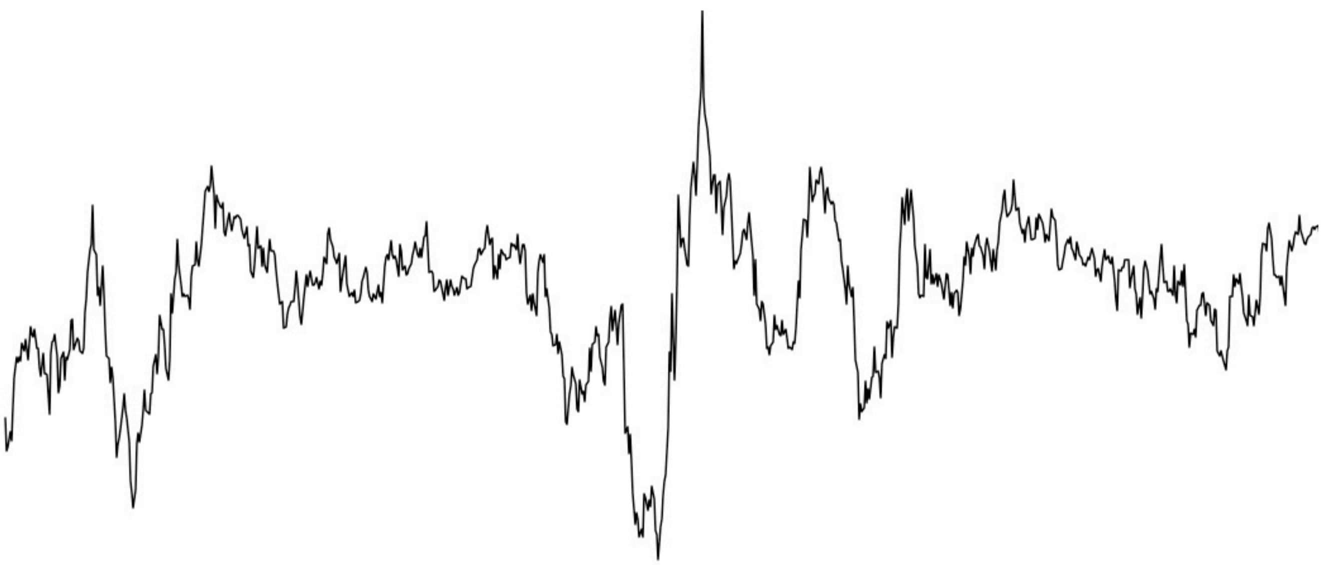

THE MEANING OF TRANSITORY

The finance and economics commentariat has been busy in the past few months educating each other about what inflation is, and what isn't. To re-cap, just because prices are going up doesn't mean that inflation is. Inflation, after all, is the rate at which prices are advancing, not the fact that prices are rising in themselves. More specifically, just because prices go up a lot in period 1, inflation can't really be said to be accelerating unless the rate at which prices go up is higher in period 2, 3 and so on. To complete the circle; if prices were falling, we'd call it deflation, and the same argument on the rate of decline would apply, with an inverse sign. The amount of time spent by economists pointing out this trivial point is mostly an attempt to assure each other, and policymakers, that the spectacular CPI and PPI headlines we presently see on the screens are nothing to worry about. It follows that slowing the pace of asset purchases, not to mention raising interest rates, would be a grave and unforgivable error. The path of virtue of righteousness is

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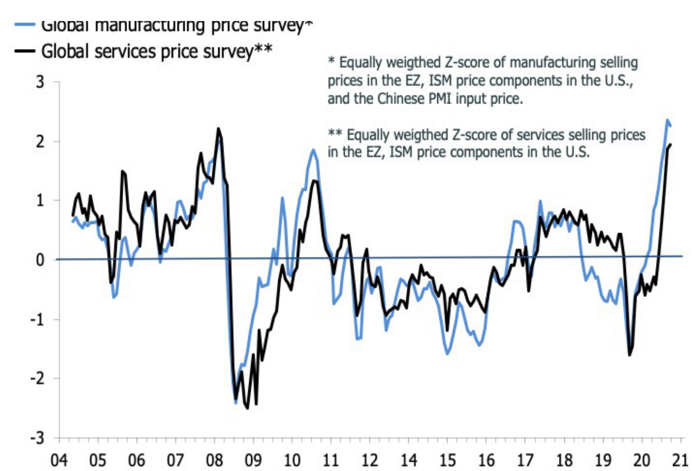
paved with freshly fiat currency created by a non-budget constrained sovereign, or something. I know that I sound like a cynical, and boring, crank with this line. But I persist that it is impossible to adequately analyze the interplay between markets, the economy and policy at this point without factoring-in the overwhelmingly "politically correct" lens through which the mainstream looks at the world.

Meanwhile on inflation, the bond market has long since voted down the reflation trade, offering up strong support for those arguing that rocketing inflation is both transitory and, in any case, driven by a one-off surge in prices in a few components. Used car prices in the US is the example most cited, but there are other candidates, chiefly of which are energy prices and prices in so-called Covid-sensitive sectors.

This implies, again, that the number we see on the screens conveys a false view of the world. This is tantamount to gaslighting those on the receiving end of the current bout of inflation, or higher prices if you will, but I am somewhat sympathetic to the point.

As a Eurozone economist—whose job it is to read the entrails of the EZ HICP data—I agree with the idea that not all is what it seems in the headline numbers. Base effects from last year's temporary VAT cut in Germany, for example, currently is the main driver of higher headline and core inflation the euro area, alongside some one-off increases in Covid-sensitive prices. The former will evaporate in January, indicating that neither the ECB nor euro area forecasters should jump the gun at this point. I doubt they will, but you never know.

fig. 01 /Where next, but down? - **fig. 02** / Sideways or down in the next 12 months?



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I can't help but feel, however, that transitory means different things to different people, not to mention policymakers. I am not a big fan of the argument that something has to go down just because it is high, but then again. It is difficult to look at the first chart above and conclude anything other than both headline PPI inflation and firms' price expectations moving lower in the next six-to-12 months.

Taking into account year-over-year base effects in the PPI alone, it will be difficult to sustain this rate for long. For survey-based price expectations, remember that these are diffusion indices. This means that further increases can only be achieved with *more* firms, on balance, reporting higher prices every month. This is possible, but the probability of this happening becomes ever smaller as the index reaches new highs, by mathematical definition.

Just because the two lines above are bound to fall soon doesn't necessarily mean that inflation is transitory, or at least I don't think so. ***It makes no sense to claim that transitory includes all versions of the world in which inflation does not stay at, or make, new cyclical highs on a sequential basis.*** In this sense, recent curve flattening, and sustained rise in short-term rate expectations could also be bond markets discounting a world in which inflation stays high enough to prompt policymakers to withdraw policy stimulus quickly enough to dent growth and tighten financial conditions.

The second chart above plots survey-based price expectations in manufacturing and services, both of which have rocketed recently. The extent to which they move more sideways than down in the next six-to-12 months could be a challenge for markets. Between 2016 and 2018, both and inflation and price expectations also moved sideways after having snapped higher over a 12-month period, a trend which prompted the Fed to go down the path of seeking a neutral rate of close to 3%. This, predictably, ended in tears.

The issue for markets is not that policy won't remain loose, but that the withdrawal of emergency stimulus prompts an accident in a context of very extended valuations and expectations of uninterrupted, and essentially, unchallenged price gains. The silver lining that if policymakers rocked the boat, they would quickly be forced to stabilize it again, is scant consolidation if you fall in the water. How quickly inflation falls in the next six-to-12 months, and how policymakers interpret this shift is key. Put differently, the meaning of transitory matters.