The View

MARKETS DELUDED BY DISINFLATION MIRAGE

Global Team

- A mirage of disinflation is set to emerge going into 2023
- Cool air emanating from Eurasia and particularly China will hit the hot ground of the US labour market
- FOMC talks tougher than they act and eagerness to reverse once unemployment rises feeds a market complacency to under-price longer-run inflation risk - this sums to more Arthur Burns than Paul Volcker
- But cracks in employment will reverse the Fed's course early next year, with the disinflation mirage intensifying FOMC complacency; wage growth is sticky
- The mirage eventually will disperse, revealing a higher inflation regime, while markets, in contrast, are priced for a return to pre-Covid growth and inflation
- The EA is at the Fed's mercy and the ECB will be grateful for the chance to take its foot off the brake if and when the Fed blinks
- The mirage will carry inflation expectations back down, allowing the ECB to focus on the likely recession, with the new TPI far from indefinitely infallible
- China's property market largely will dictate the extent of the mirage
- A slack labour market allows the PBoC to remain dovish, but don't expect Chinese stimulus to rescue global growth

Contents

Summary

A mirage is formed when cool air hits the hot ground. This is precisely what we think will happen in headline, and even core, inflation over the next 12 months. Cool air will emanate from China's property market and blow through commodity markets and the RMB, as well as real economy channels. At the same time, the EA recession (starting later this year) will soon open up slack, with compositional effects dragging down inflation as demand finds its new normal.

Declining input costs will bring down non-core inflation across the globe but at the same time bleed into not only core inflation, most directly through transportation, but also core goods, with shipping costs retreating too. Even services, recently stung by the leap in energy and food prices, will feel the benefit of the reversal; the easing of input prices will feed through to EA and Chinese consumers. But greater pricing power in the US will mean consumers there feel less of the benefit, while demand destruction is likely to be more rapid in Eurasia.

Wage growth remains sturdy in both the US and the EA, but we think it is significantly stickier in the former. Admittedly, the balance of labour demand and supply has tightened everywhere. But the tightening has been much more acute in the US, largely thanks to sky-high demand – and also, for more idiosyncratic reasons, in the UK. China is in a completely different boat. Wage growth has peaked and the effects are already visible in decelerating services prices.

Crucially, these features of accelerating DM wages and decelerating Chinese wages were already embedded as secular trends before the pandemic, which merely catalyzed the transition to a higher inflation regime. DM labour markets have gradually been tightening, even in the EA, and the overvaluation of the RMB translates the tightening into faster ULC growth. This change in secular trends, combined with the sheer magnitude of the pandemic-induced supply-demand mismatch in the US, means that inflation will not sustainably settle back at 2% in that country. Wage growth is now stickier, commodities and goods disinflation will give back purchasing power, and the Fed's likely premature easing (in the perspective of its own inflation target) will return real rates to negative, unleashing credit demand. Eventually, the Fed will concede that the scale of demand management required to keep inflation at 2% implies unacceptably high unemployment, and will shift the inflation target higher.

In the meantime, however, the pincer between a hawkish Fed and weakening global demand remains in place and the Fed will allow itself to be taken in by the mirage only once employment cracks, which we think will happen early next year. And the sheer determination of central bankers to avoid being labelled as the next Arthur Burns means markets are probably complacent about the peak in the Fed funds rate, even if they may have the timing of the reversal roughly right – a reversal that will channel Arthur Burns after all. The combination of weaker employment and decelerating prices will cause the Fed to blink, relieving the ECB of the dilemma of whether to focus on the euro or growth. The EA's likely recession, combined with dropping inflation expectations as frequently purchased items disinflate, and heightening political strife mean that the ECB will gladly take the opportunity to take its foot off the brake.

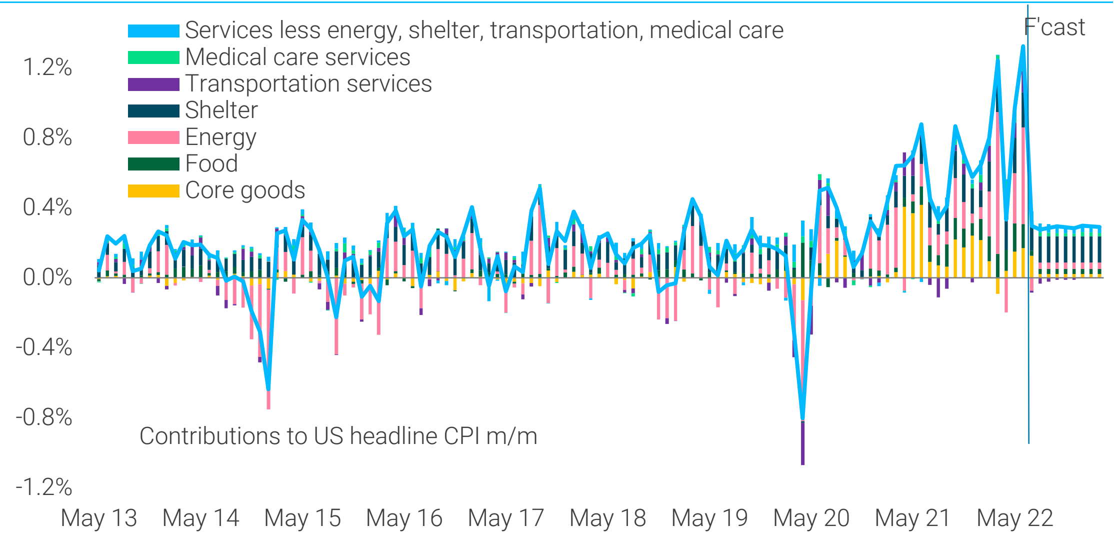
An escape from the zero-Covid policy in late Q1/23 could reinvigorate services inflation in China. But we expect property market woes to remain and think the PBoC will be cautious about over-reacting, particularly in the context of a dovish pivot from DM central banks.

Market perils remain. Fading rallies remains the best policy, with a tendency toward dollar strength broadly persisting. Markets remain complacent about central bank determination to squeeze out inflation in the near term. But policymakers will blink as soon as the traditional labour market triggers are met. Disinflation will then breed complacency back in. Expectations of a return to pre-Covid growth and inflation will be dashed.

The top-level story in charts: Cross currents

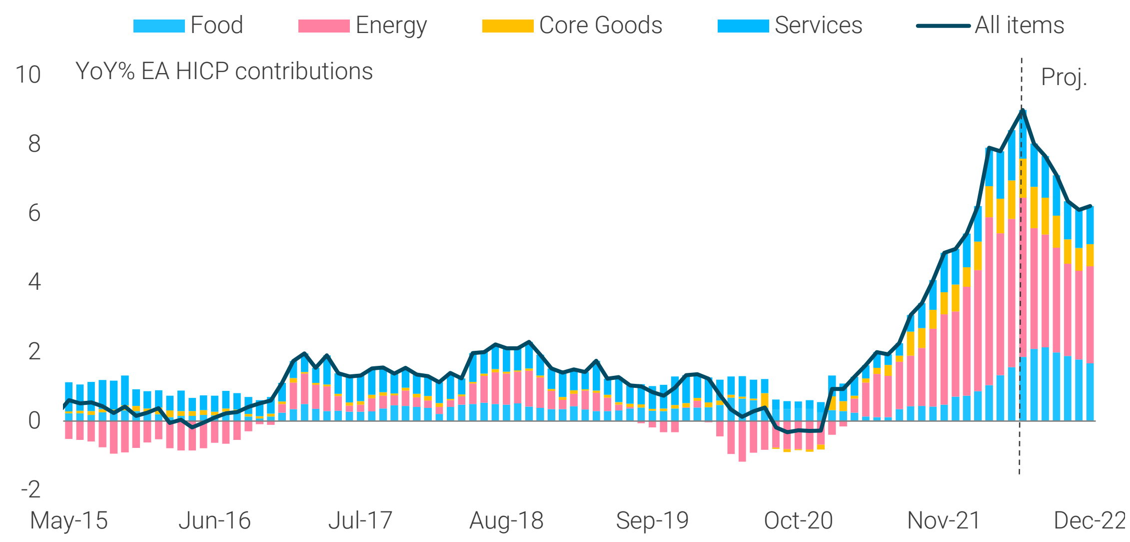
Headline

Pace of rise in US headline CPI will soon slow significantly but mainly thanks to non-core



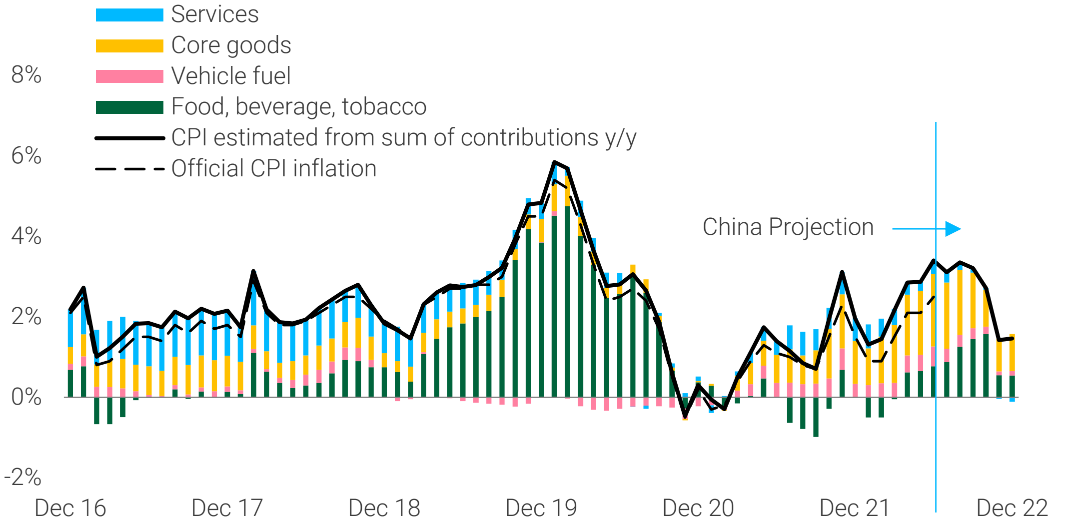
Sources: Datastream, TS Lombard.

EA inflation is headed downward for more or less the same reason



Sources: Datastream, TS Lombard.

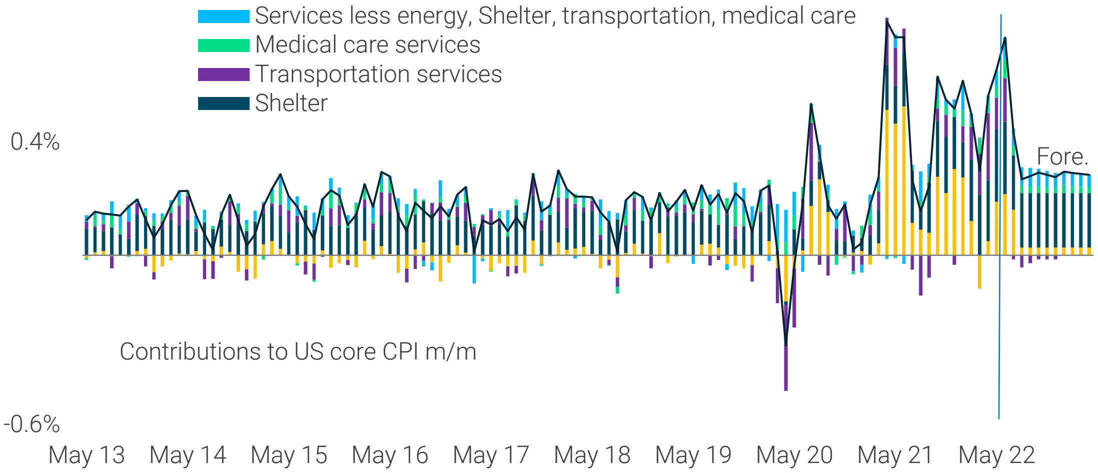
China's disinflation story is already more advanced, with services on the back foot



Sources: Datastream, TS Lombard.

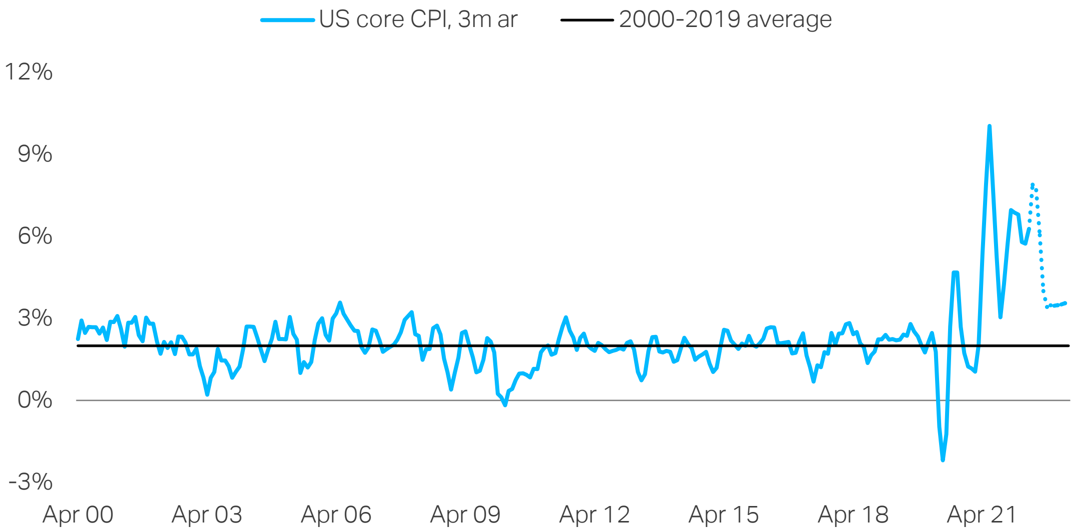
Core

Oil price declines will bleed into core and core goods could still disinflate, but elsewhere the heat remains



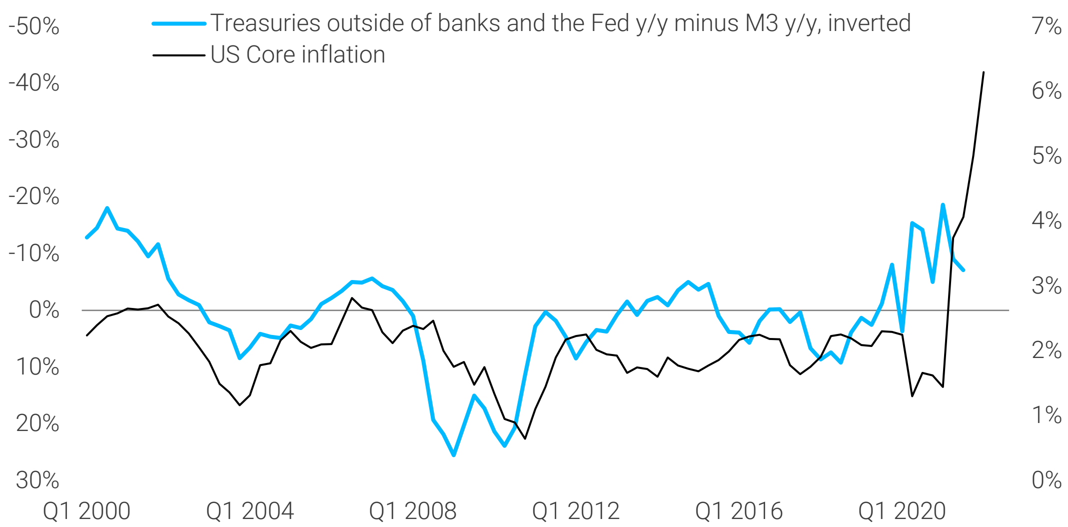
Sources: Datastream, TS Lombard

Core US inflation is unlikely to return to previous trends before the Fed blinks



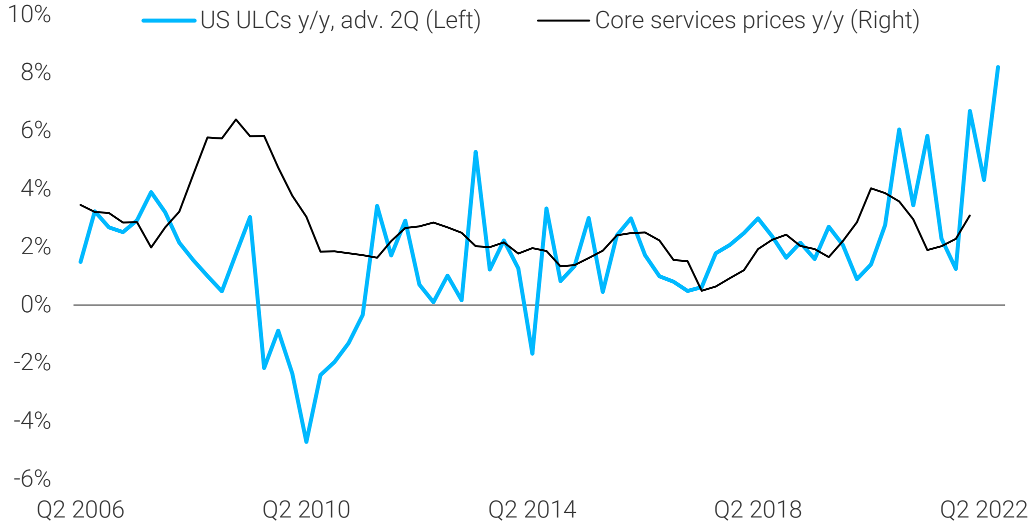
Sources: Datastream, TS Lombard.

QE effects explain a lot, but not everything



Sources: Datastream, TS Lombard.

Wage pressures imply more core inflation to come



Sources: Datastream, TS Lombard.

Disinflation: Energy, food and, for the main part, core goods?

It appears the peaks are now in for industrial, agricultural and energy commodities. The effects of this peaking were notably absent in June inflation across the majors, but they should start to show up in the non-core items as soon as this month and shortly thereafter in transportation, which bleeds commodity prices directly into the core. Other core items should feel the benefit, too.

The main point to flag here is if commodity price declines fail to show up in CPI in the next couple of months, then we will know something is wrong. And that is very possible. Pre-Covid-based models of feed-through from commodities to consumer prices have systematically underestimated the extent of inflation throughout the pandemic. Our short answer to why this is the case is that the sharp mismatch between demand and supply injected an extra helping of pricing power during the pandemic, and this happened in a way that linear models were unable to keep up with.

Nobody knows how these relationships will settle down, but we are assuming some – but by no means - full reversion, particularly in the US. In short, we allow our CPI forecasts for the US to drift back towards the old relationship but never fully reaching that previous destination. Instead, we think the environment is going to be more inflationary going forward. The downside risk to this forecast is either that the downturn in commodities prices is more severe than we imagine or that pricing power evaporates more rapidly.

Assumptions in our commodity-driven forecasts and the second-round effects

	Commodity prices	Pricing power at the consumer level
Energy	We continue to assume Russia will cut off gas supplies to Europe only if backed into a corner. Risk premia will remain elevated, but the downside risk is that weakening demand, particularly after the summer holiday season, takes more of the heat out of energy markets than currently implied by futures markets. For now, we think the futures curve has it right.	US: Demand overall remains more robust than in the rest of the world, meaning the underlying supply-demand mismatch is more severe – we have accounted for this in our forecast. In any case, efforts to recapitalize in the sectors that were worst hit by Covid could produce intense sectoral effects, making pricing less sensitive to weakened demand. EA: Demand is more likely to give way than in the US, largely because the labour market mismatch is less severe and cost-push inflation will erode purchasing power. Services surveys suggest there is already weakening, even as pent-up demand is released over summer. But the effects of energy are pervasive and surveys show that at this stage, firms remain eager to pass them on. China: Demand has already weakened sharply, leaving little pricing power. Lockdowns reduce demand for transportation. The NDRC has started to lower benchmark energy prices as global costs moderate.
Agricultural	Agri prices should continue to moderate. Hurdles to grain exports from Russia and Ukraine appear to be diminishing, helping pull down prices. Chinese pork prices will add pressure to CPI via base effects, in reality pork is in plentiful supply and cheap on a historic basis.	US: As above EA: As above China: Firms will struggle to pass on price gains from higher input costs.
Industrial (relating to core goods below)	Risks of a more serious decline in commodity prices are likely among the most significant in our inflation projections. China's property woes are likely to keep industrial prices on the back foot, while the gradual erosion of demand after the spike of core goods prices during the pandemic should help take some of the wind out of these input prices. But the labour market matters more to the Fed than core goods prices.	US: Rotation of demand toward extra-home services should dampen demand for core goods, but aggregate demand means that the mismatch to supply is significant, leaving pricing power remaining. Consumer prices, therefore, are unlikely to feel the full benefit of declining input prices, with margins taking some of the gains. EA: Rotation story is similar to that of the US but demand will weaken more sharply, so we have assumed less pricing power in our forecasts. China: Despite significant lockdowns, online sales are struggling, providing little evidence of pricing power. Input price falls are likely to be passed on to consumers.

Source: TS Lombard.

The result of these downside risks materializing would be to increase the mirage of disinflation. In any case, we think the Fed will blink once the unemployment rate gets over 4.5%, which likely coincides with two to three months of falling employment levels (always the signal for Fed tightening to stop-and-reverse). If, between now and worsening employment, inflation decelerates faster than we assume in our base case, the likelihood of bailing on getting to a positive real funds rate will increase. Our labour market analysis below, as well as our wider secular story on the long-term trifecta foresees a more inflationary environment for the US and DMs in general in the 2020s overall. But China's outlook is quite different, as the country engages in a multi-year deleveraging process, which implies a battle to save (the paradox of thrift). As a result, China represents the cool air of deflationary forces in the global economy. As the extent of China's property market woes gradually becomes clear, this cool air will hit the hot ground of the US labour market and a mirage of disinflation will form. If these downside risks materialize in the next six months or so, the likelihood of the Fed being fooled increases.

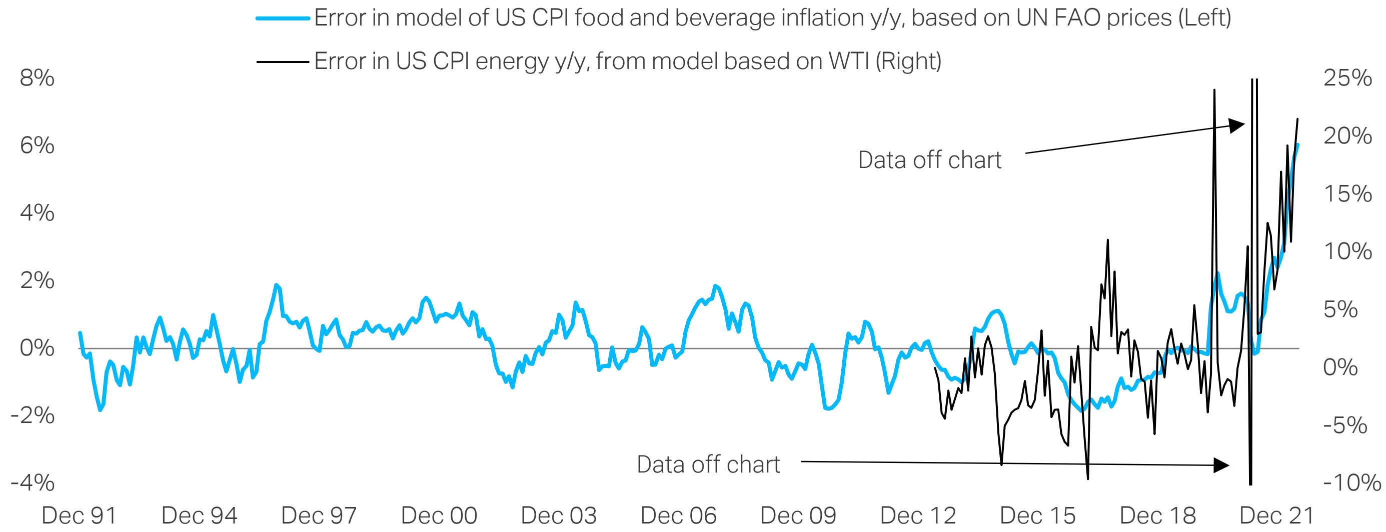
For now, we maintain that the US labour market still dominates; and even if there is disinflation in commodities (in the CPI basket: energy, food and core goods), the labour market mismatch will remain large, keeping wage inflation elevated even as labour demand softens. The Fed's self-declared priorities are in the following order: public health, labour market, inflation and global markets. **So, even if inflation decelerates by more than our projections here show, it is the labour market that dictates the Fed's turning point. While commodities markets pose downside risks to inflation, DM and particularly US labour markets and credit pose upside risks.**

If the worst happens in China and the property market wobbles intensify, this is bound to reverberate across global financial markets (think Japanese banks' exposure to Chinese short-term dollar liabilities, for example). In this regard, as highlighted in our latest issue of *Global Financial Trends*, widening in the yen cross-currency basis can be a tell-tale sign of trouble in China – i.e., Chinese banks trying to secure dollar liquidity through the Japanese banks as stresses build. The priorities might then change, as it would imply a new era for RMB and dollar strength. But our central case assumes that these significant dangers remain as tail risks as Beijing does whatever it takes to allow the economy to muddle past the Party Congress and Covid-19.

A wave of mortgage strikes, however, could bring these risks to the forefront much earlier. Chinese home buyers are threatening non-payment of home loans unless developers complete construction on their paid-for, but not-built apartments. So far, well below 1% of mortgages are impacted; however, it is a worrying trend with potentially large-scale social and financial spillovers. We estimate that activity has stopped on 10% of the total residential floor area under construction. A back-of-the-envelope calculation puts the current construction area at 6.9bn square metres, with the total amount of stalled construction at roughly 690mn square metres. Based on a price of 10,000 yuan/square metre, the corresponding asset value of stalled construction is RMB 7trn. Assuming 80% of projects are pre-sold and the average down payment is 40%, there is approximately RMB3.3trn in mortgage loans that could join the "strike". This represents 7% of total outstanding mortgages, a potentially systemic risk to financial (40% of banks loans to real estate) and social stability (70% of household wealth is in property).

China's property sector is too big to fail and we expect stronger action from Beijing. The government response thus far has focused on local governments, banks and SOEs. We think greater indication of support will be needed (including liquidity provision for certain projects) and will, in fact, be forthcoming in the coming weeks. Even with extra government backing, the payment strike will hit property sales and funding and further delay the cyclical bottoming of sales and investment. More widely, monetary policy transmission is further impaired via weaker credit demand and the "national service" (higher NPLs and lending to developers) being performed by banks. China's recovery is stalling. We stay well below consensus growth and above consensus stimulus. Only when the zero covid policy lifts likely late Q1/23 (a partial easing is possible afte the Party Congress) will the recovery accelerate. For the global economy weak China activity and demand is strongly disinflationary, as we outline in detail below.

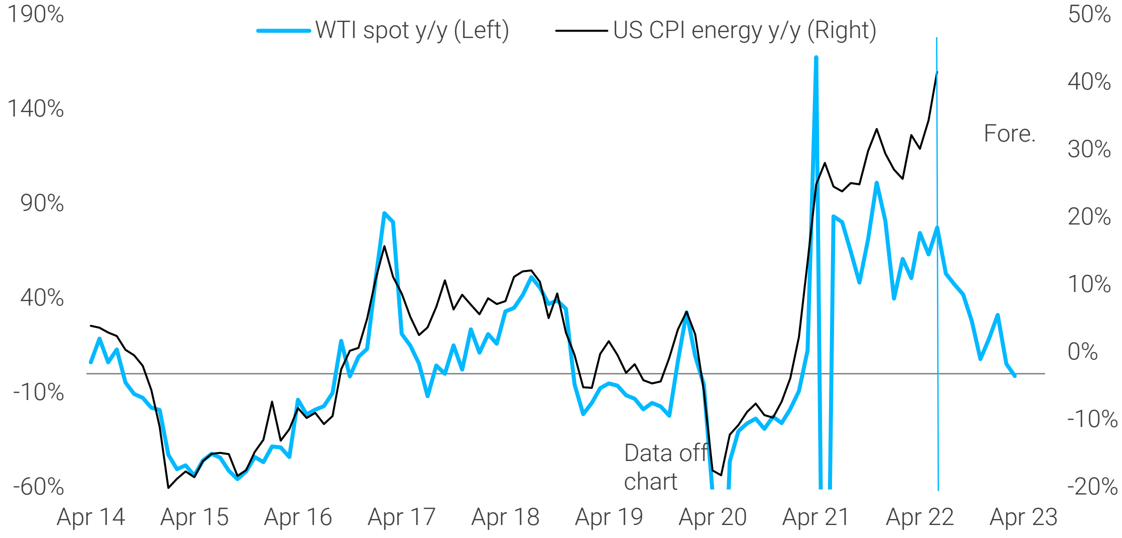
US CPI non-core inflation has far outstripped what would be expected given commodity prices



Sources: Datastream, TS Lombard.

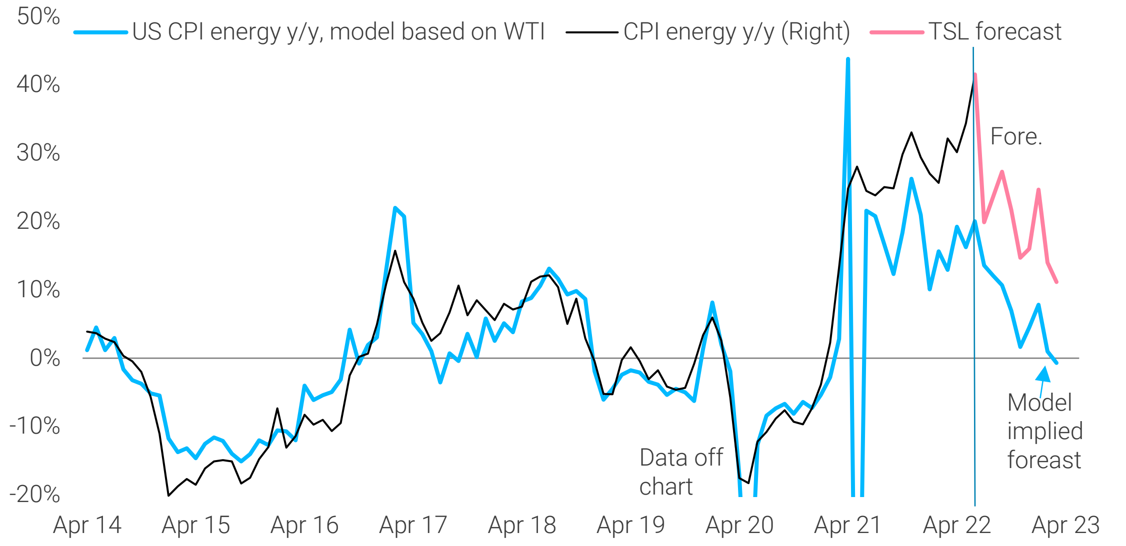
Energy

Recent oil price declines (with still a bit further to go) should pull down US CPI energy



Sources: Datastream, TS Lombard.

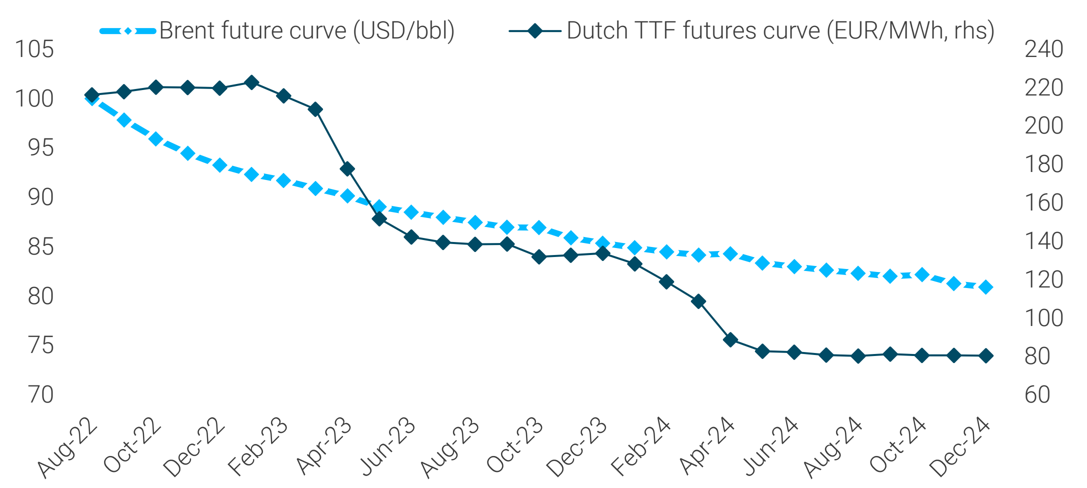
But don't take the statistical models at face value



Sources: Datastream, TS Lombard.

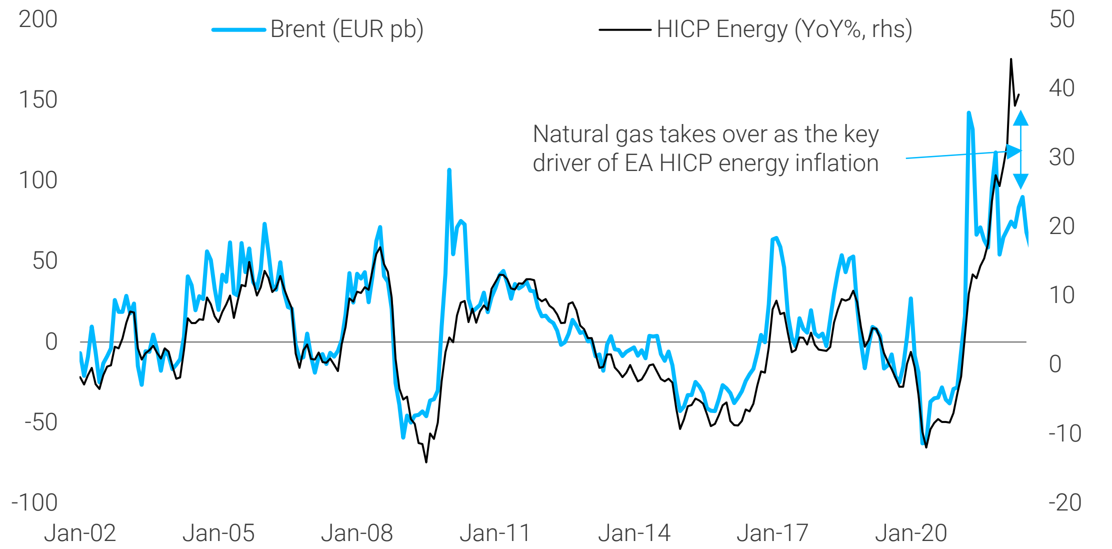
Unlike in the US, where demand-driven inflation is a major factor behind headline inflation, in the EA, energy (not least owing to its indirect impact on core goods and food prices) will remain the most important driver of HICP. Historically, HICP energy has closely tracked Brent prices; but since the beginning of the EA energy crisis in 2021H2, natural gas costs have taken over as the key variable, while significant EUR/USD weakness has compounded the cost of imports (remember: the EA is a structurally large importer of energy products). To make projections we use the future curves, which should now be discounting the risk of continued decline in Russian gas supplies, if not a complete cut-off. However, amid ongoing geopolitical pressures from Russia and the disruption to France's nuclear sector – which accounts for a large part of the country's electricity needs, forcing France to import power from Germany – the upside risks for EA energy inflation are extremely high, as shown by the fact that that the Dutch TTF futures curve continues to jump around and, since last week, it has shifted higher for contracts until the end of the year on reports that Gazprom will stop another Nord Stream I turbine, reducing gas flows to 20% of capacity. Energy clearly poses a major risk in both directions to our forecast.

Upside risk for EA energy inflation



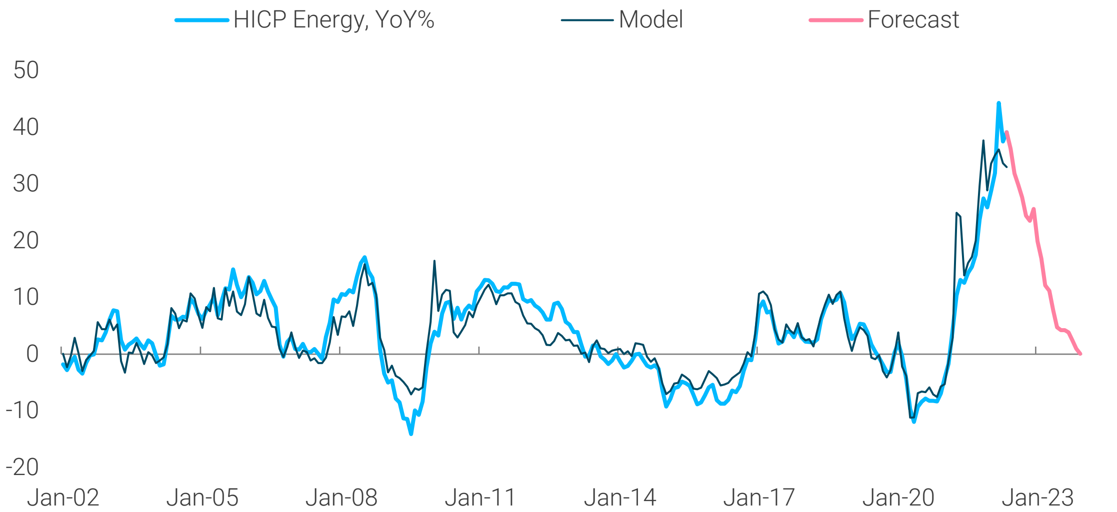
Sources: Bloomberg, TS Lombard.

Natural gas crisis has driven EA inflation higher…



Sources: Bloomberg, Datastream, TS Lombard

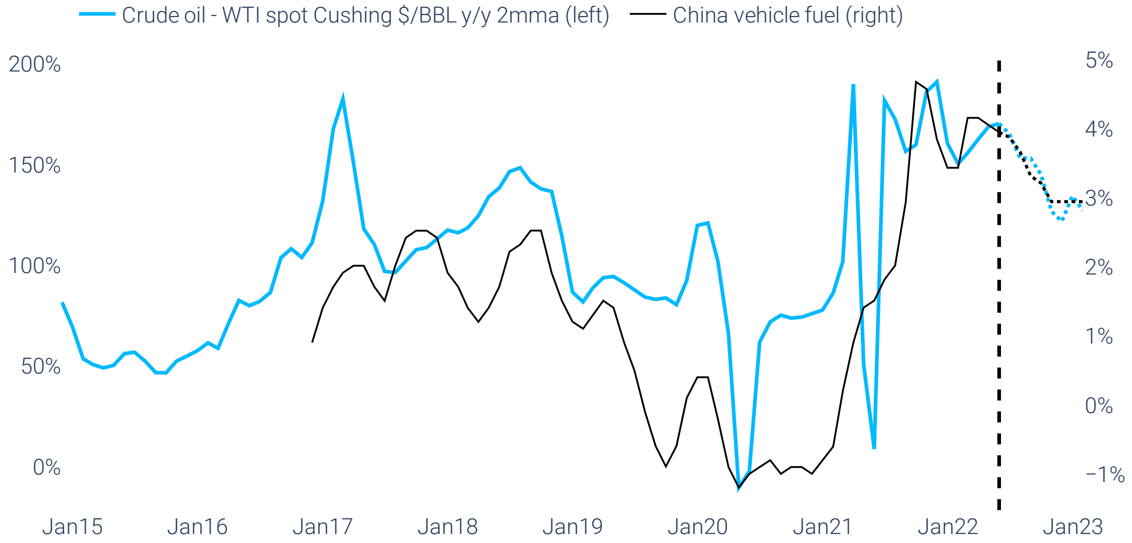
... but futures for both brent and natural gas now suggest a sharp reversal



Sources: Bloomberg, Datastream, TS Lombard.

Energy is statistically tricky in China as the authorities do not decompose its parts, and the implied weights (official weights are not published) seem on the low side. But vehicle fuel and utilities inflation should continue to trend down.

China's energy costs inflation should soon retreat

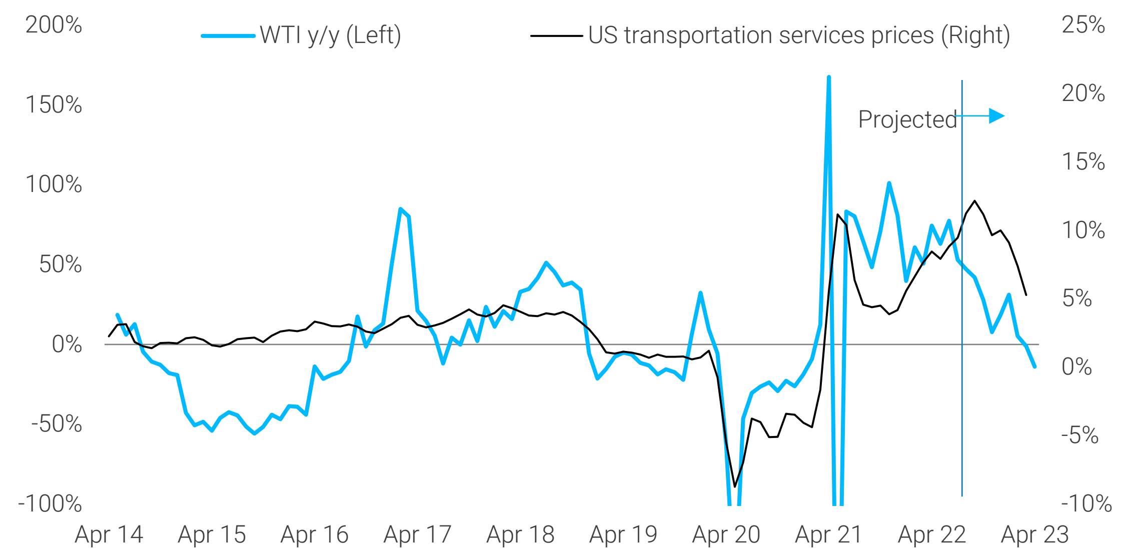


Sources: Datastream, TS Lombard.

Transportation

Transportation costs are the most direct channel for energy costs to leak into core inflation and they have a large impact across the majors. Airline fares have been a major source of upside surprises, as demand shifted back to the transportation sector after two years of atrophy. But with the prices of oil (and jet fuel) retreating, we should start to see negative contributions at the margin in the coming months. Still, disrupted labour markets and ongoing attempts at recapitalization in the sector, however, are a couple of reasons why CPI transport prices will remain stickier than expected based purely on pre-Covid relationships.

Revenge summer demand remains hot, but input cost inflation is retreating fast



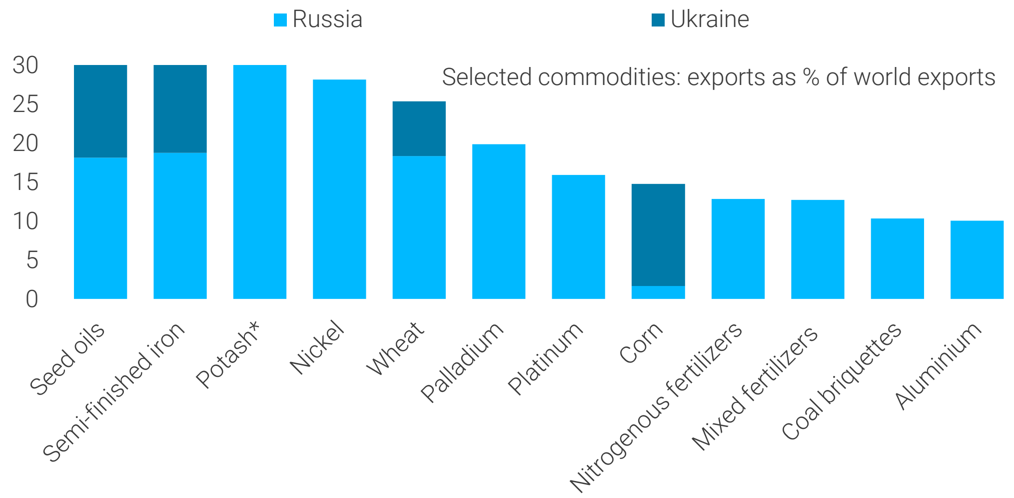
Sources: Datastream, TS Lombard.

Food

Political drivers suggest that wheat and other staple grain prices that are quite heavily dependent on exports from Russia and Ukraine should continue to ease. Turkey has brokered a deal – formally signed on 22 July - designed to facilitate the resumption of seaborne exports of stockpiled Ukrainian grain from the country's Black Sea ports and the removal of indirect sanctions blockages to Russian grain exports.

Moreover, last week the EU announced the relaxations on sanctions on Russian banks that have been impeding payments for grain exports from Russia, which are around double those from Ukraine. Those impediments have been ongoing despite agricultural products and fertilizers being excluded from the sanctions regime. The sanctions-related blockages have been causing Europe and the West to lose the "PR" war in Africa over the Ukraine situation, hence the U-turn on the part of the EU. In short, we expect food prices to start retreating.

Russia-related agricultural stress should continue to abate somewhat



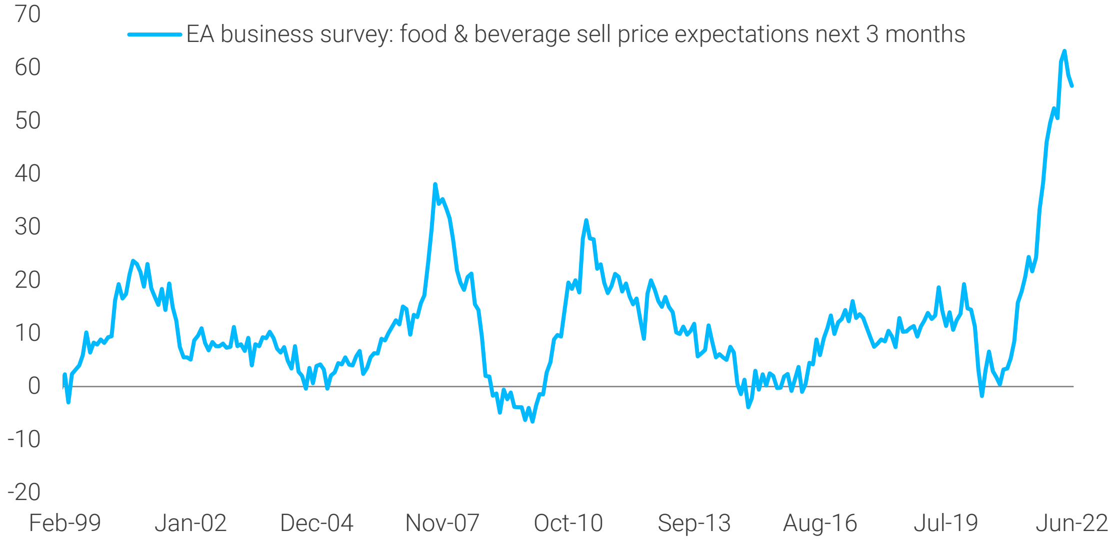
Source: Observatory of Economic Complexity, TS Lombard (*includes Belarus).

Food prices should start to come back down but risk premia will remain elevated

Sources: Datastream, TS Lombard.

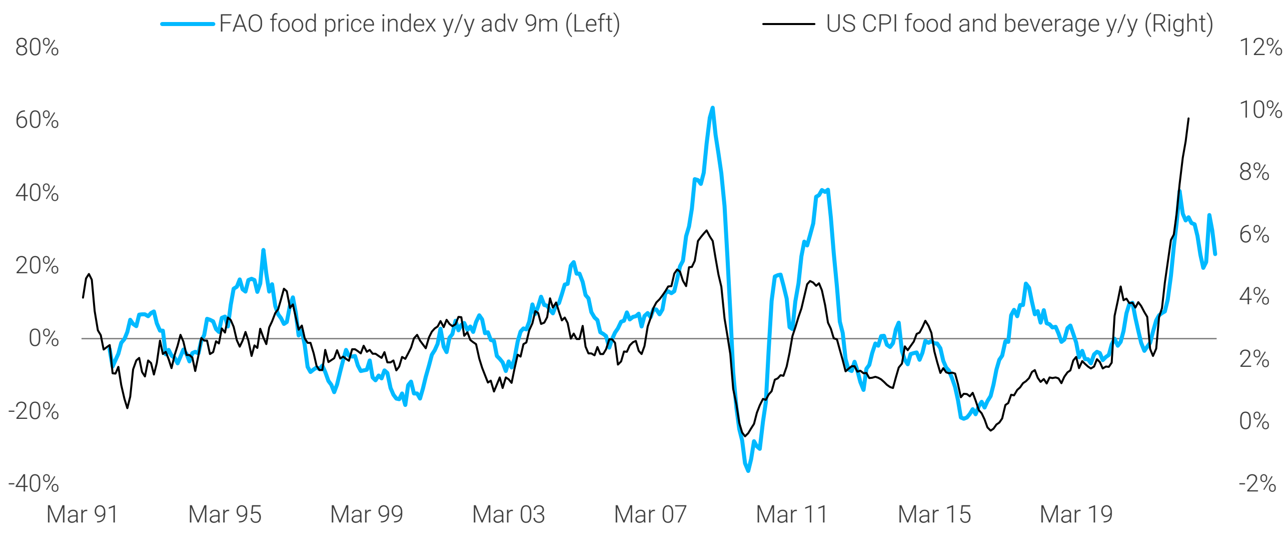
Global agricultural commodities prices have peaked, but owing to the large energy dependency of the food industry (think here of fertilizers, a derivative of natural gas, but also of oil and electricity for food processing), firms' selling price expectations in the sector have now just peaked.

Higher energy costs have also kept food price expectations high till now



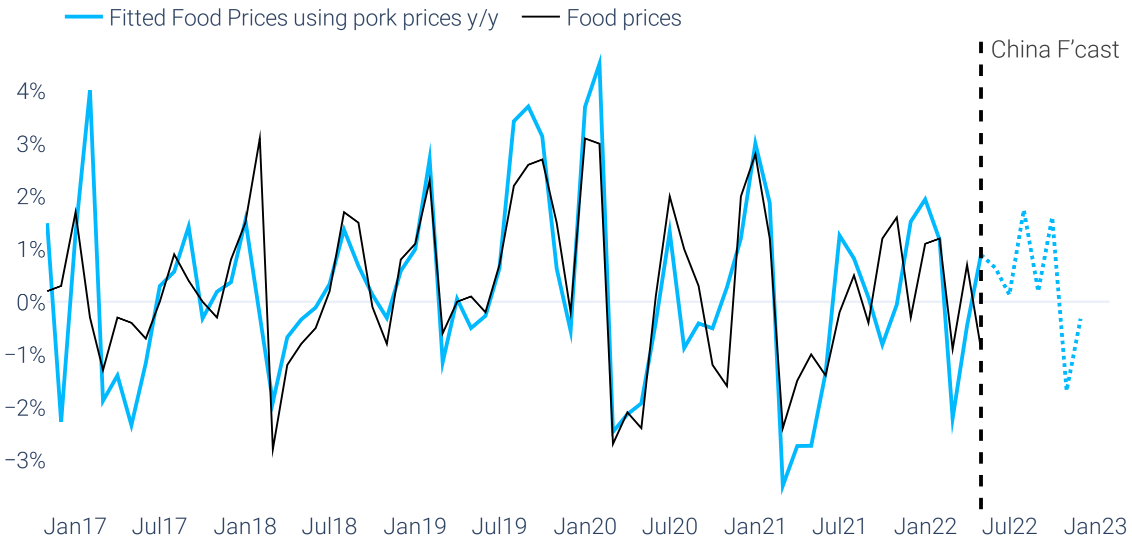
Sources: Datastream, TS Lombard.

US CPI food inflation has far outstripped expectations



Sources: Datastream, TS Lombard.

Pork prices could keep Chinese food inflation going, but futures markets are already settling down



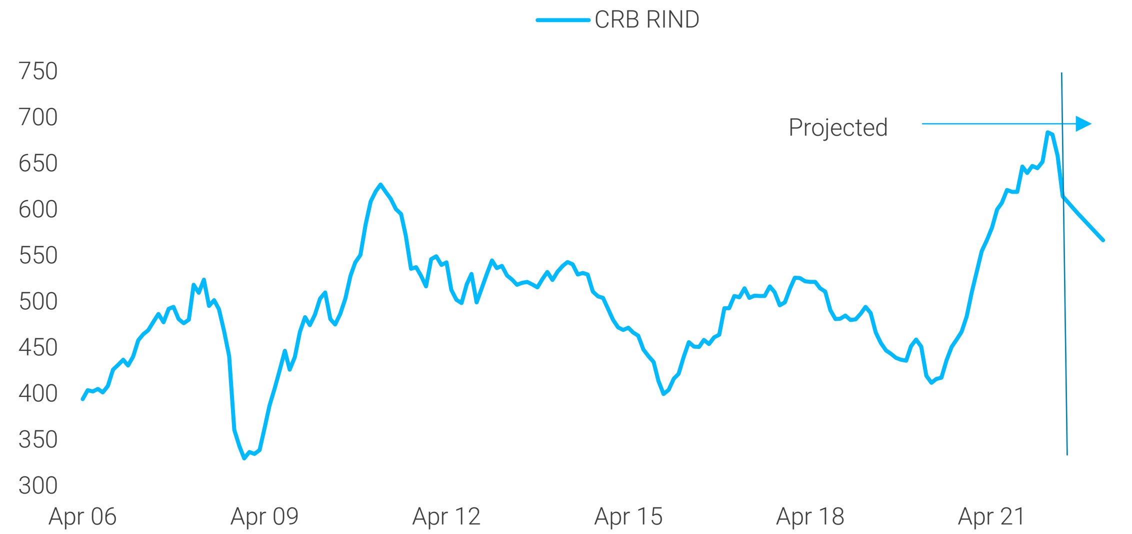
Sources: Bloomberg, TS Lombard.

There has been much talk of a new pork price pressure emerging in China, due to higher input costs and a pick-up in catering demand. Futures markets rebounded in May and June, but the worries appear to be ebbing, as we forecast, judging by prices further out the curve. Regardless, pork prices have not – and will not – set PBoC policy. The property market and financial concerns (explained above) and Covid-crippled services prices and a weakening labour market (discussed below) far outweigh any heat in pork prices.

Core goods

Input prices are dropping almost across the board. This should help bring down core goods inflation, but consumers across various regions will feel the benefit to varying degrees.

China-related industrials are likely to deflate (our forecast here is conservative)



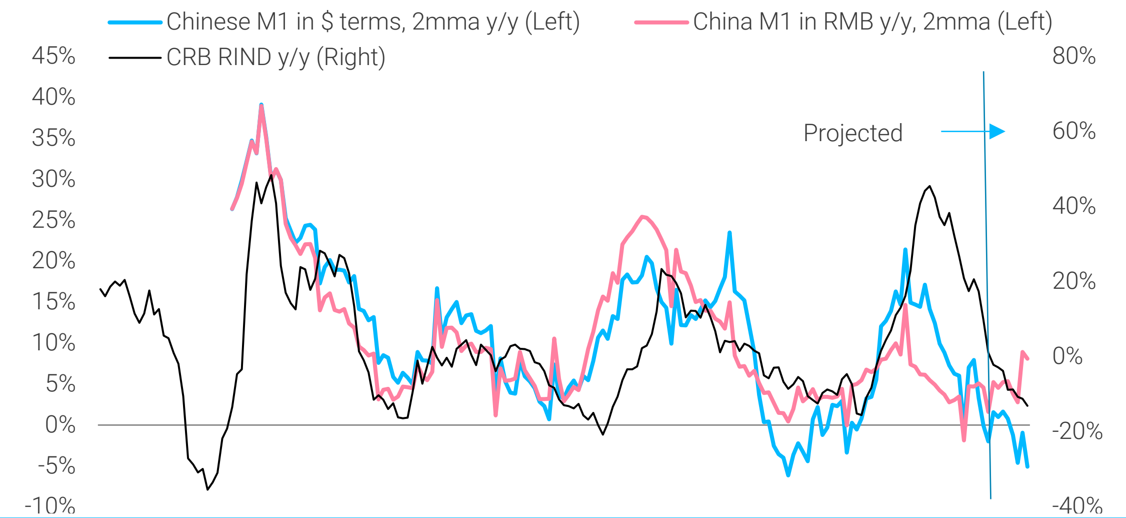
Sources: Bloomberg, TS Lombard.

China's property market woes mean that risks to our near-term forecast for raw industrial materials (see chart above) are firmly to the downside, posing downside risks to global core goods inflation. For now, we continue to take our cue from Chinese M1 trends, in dollar terms.

The PBoC's policy put remains impaired by credit saturation, while the ability to create liquidity in recent months has been further damaged by lockdowns and their further hit to housing demand.

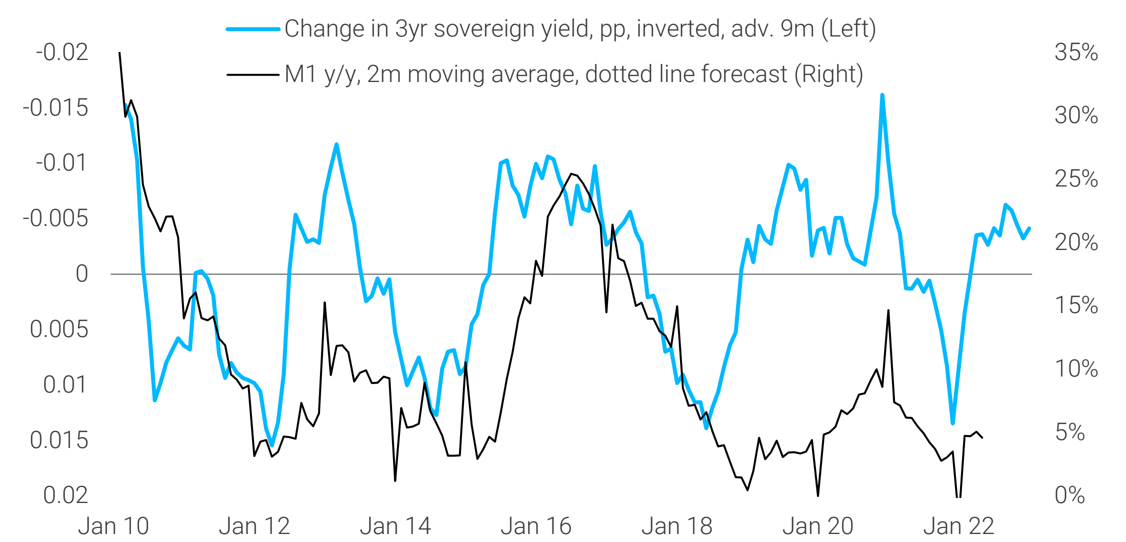
In dollar terms, the switch to RMB depreciation this year further reduces the purchasing power of this erstwhile driver of industrial commodity prices. To cut a long story short, the property market is not going to come to the rescue of commodity prices this time around, and the PBoC is struggling to create liquidity, although an improvement was finally indicated in the June data.

Chinese liquidity trends are failing to turn the corner



Source: Datastream, TS Lombard.

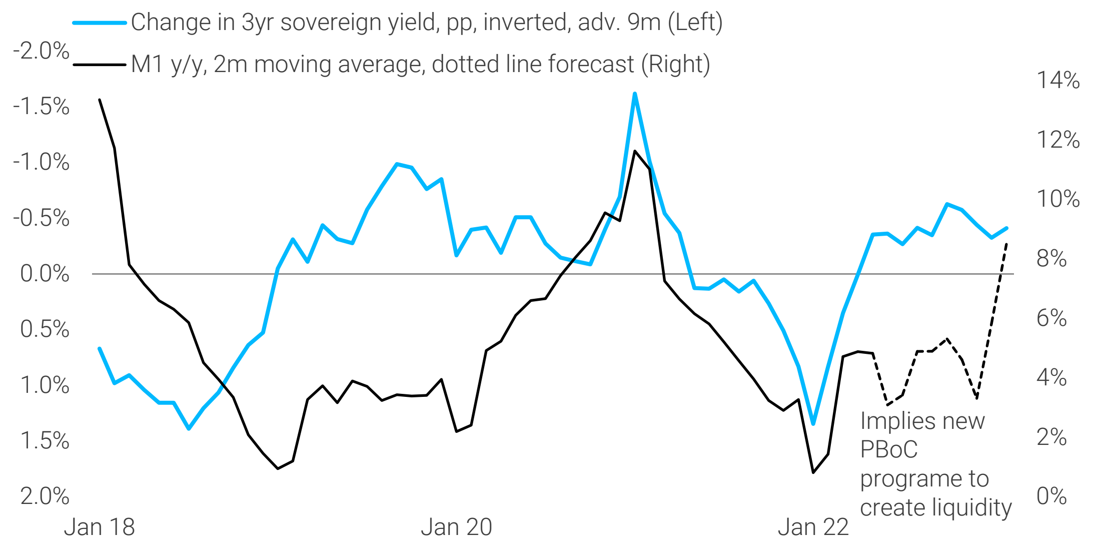
Chinese monetary policy transmission has reset…



Sources: Datastream, TS Lombard.

Liquidity growth will pick up – either as a result of new programmes that create liquidity directly in the economy (i.e., QE under another name) or owing to the relaxation of Covid restrictions next year or, most likely, because of both. But until liquidity growth picks up discernibly in dollar terms, it is hard to see a bottom in industrials inflation. And even when the liquidity trough is in, it will be money supply, rather than demand, that is the driver. Meanwhile, it will take years to fix the property market, meaning the old trigger for a bottom in industrial commodity prices might not work this time around. Further deflationary threats emanate from the risk of a new era for the RMB, as discussed here.

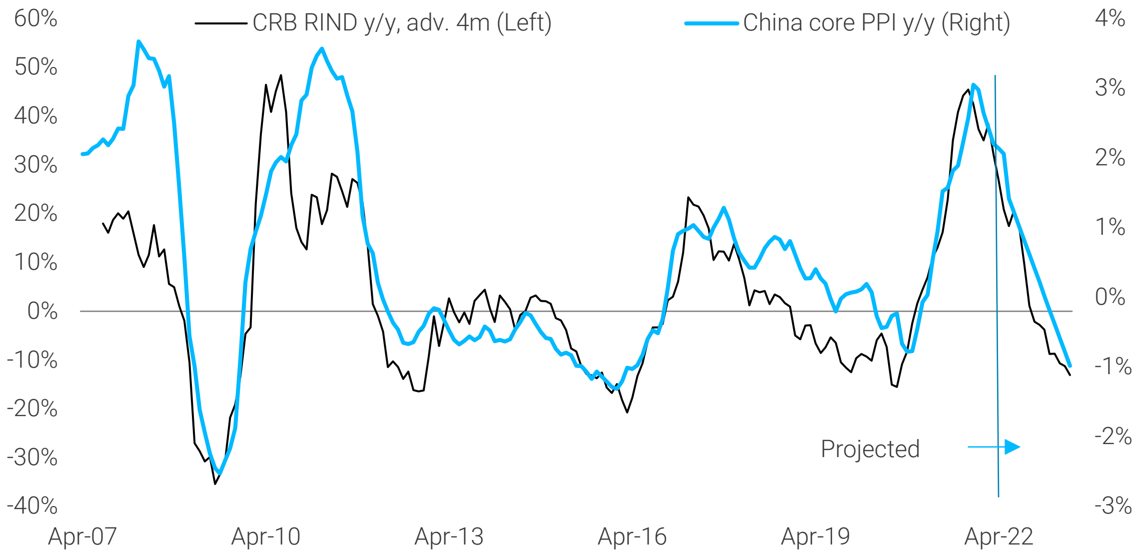
... with longer lags until easing generates liquidity growth



Sources: Datastream, TS Lombard.

Developments in industrial commodities usually filter through to core PPI prices in China with a lag of around four months, meaning the downtrend from the recent peak is likely to continue for some time.

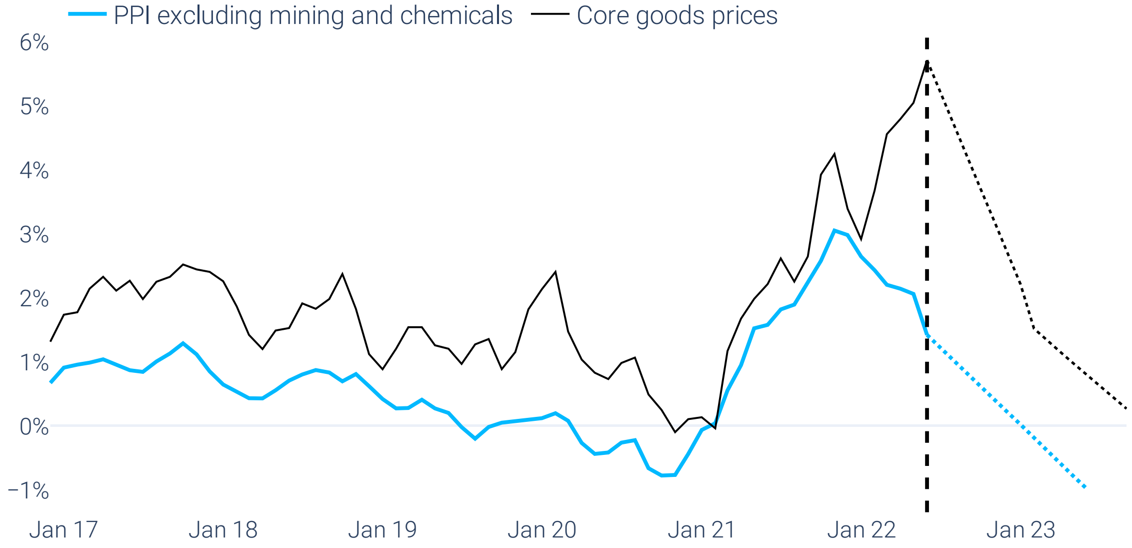
This will keep Chinese core PPI on a downtrend



Sources: Bloomberg, Datastream, TS Lombard.

These dynamics will pull down Chinese core goods inflation, which admittedly appears to have taken off once again in recent months. But the exact measurement of core goods inflation is uncertain in China's case (we estimate it), and the signal from core PPI is clearly pointing downward. Pricing power seems unlikely to hold up in the face of the weakening labour market.

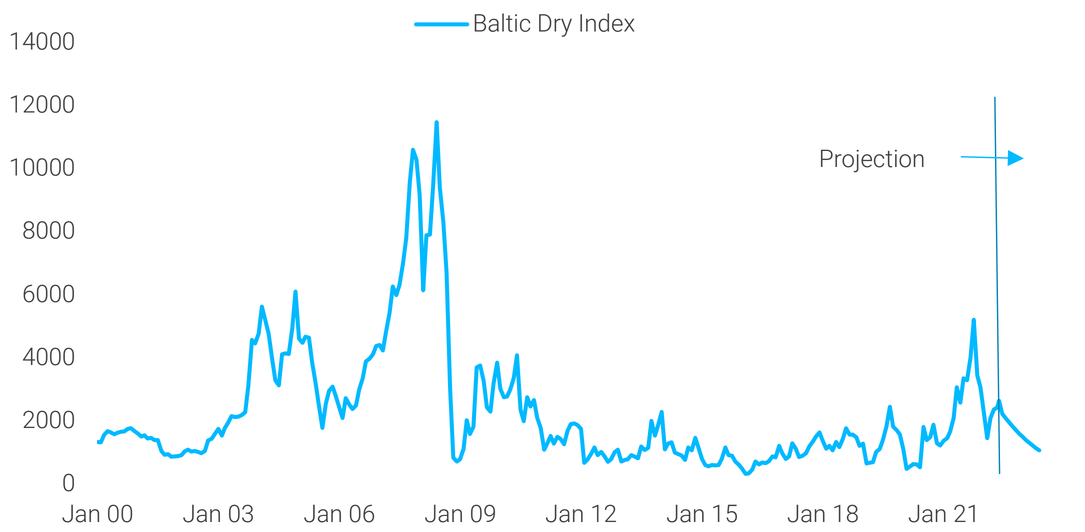
China's core goods inflation will soon roll over as commodities declines feed through



Sources: Datastream, TS Lombard.

In "normal" times, China's core PPI inflation is a pretty good fit for a simple model of global core consumer goods prices. But core goods price inflation in the US and the EA has taken off by much more than expected, based purely on China's PPI trends, with the spike in shipping costs explaining much of the difference. Shipping costs peaked in October last year, though, and we assume they will soon resume a downtrend. Finally, declines in energy costs should help, too.

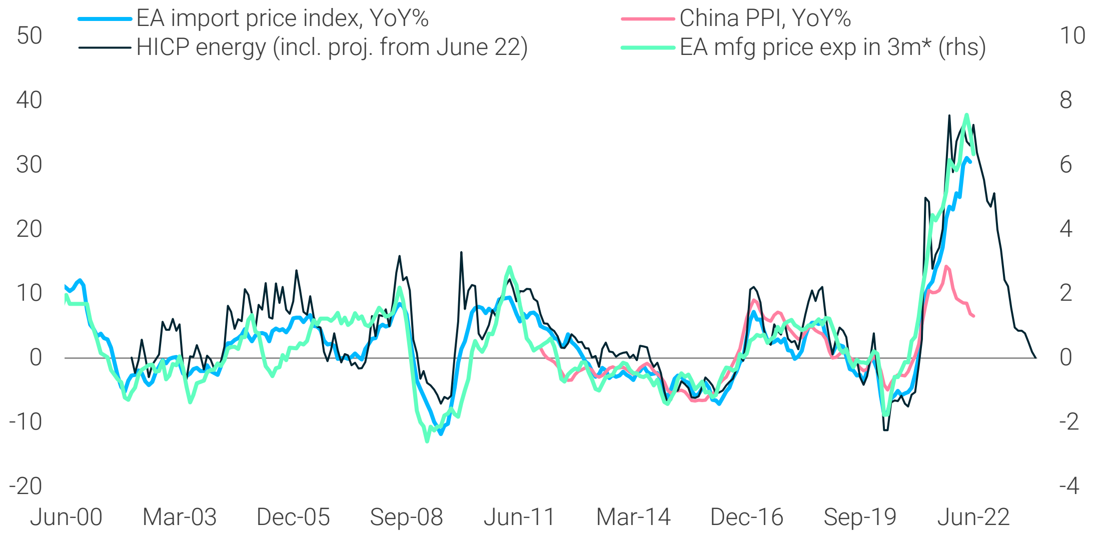
Shipping costs are likely to drop back further



Sources: Datastream, TS Lombard.

Even in the case of the EA, it is not plain sailing to core goods disinflation. Significant EUR/USD weakness since the beginning of the year leans against these other disinflationary forces. And firms' selling price expectations have continued to rise, reflecting the effort to pass on to customers the new cost increases in key energy inputs. Nevertheless, as recent ECB surveys show, input costs are the most important factor determining EA firms' pricing decisions since 2021, and that should remain true on the way down. Consumer surveys show that with a recession now likely in 2022H2, demand support for higher goods prices is crumbling. Weaker demand should focus minds on sales.

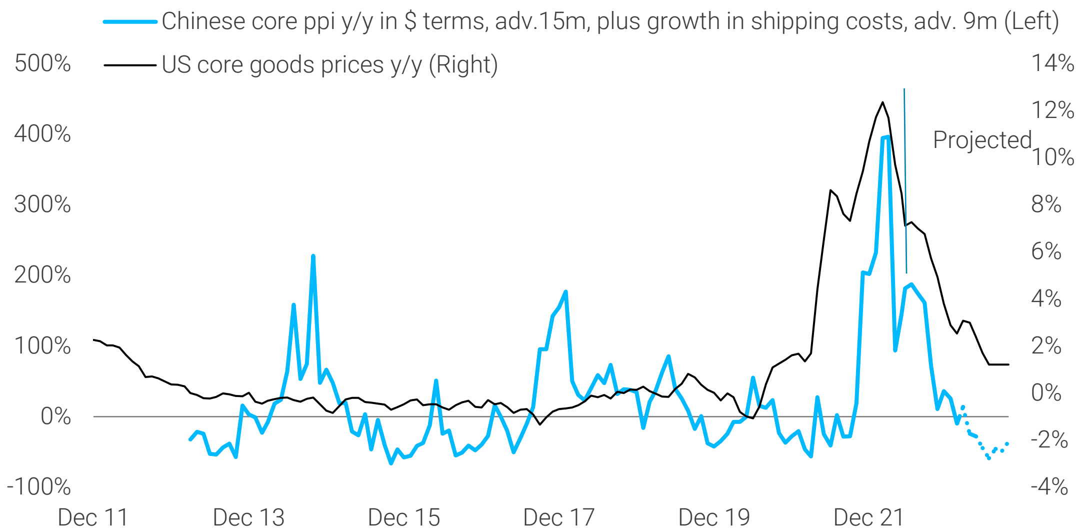
EA input cost inflation should drop sharply



Source: Bloomberg, Datastream, TS Lombard.

Euro and RMB losses are dollar gains, however, and this year's strength provides further downside to US core goods price inflation. So, the overall decline in input costs is greatest in the US.

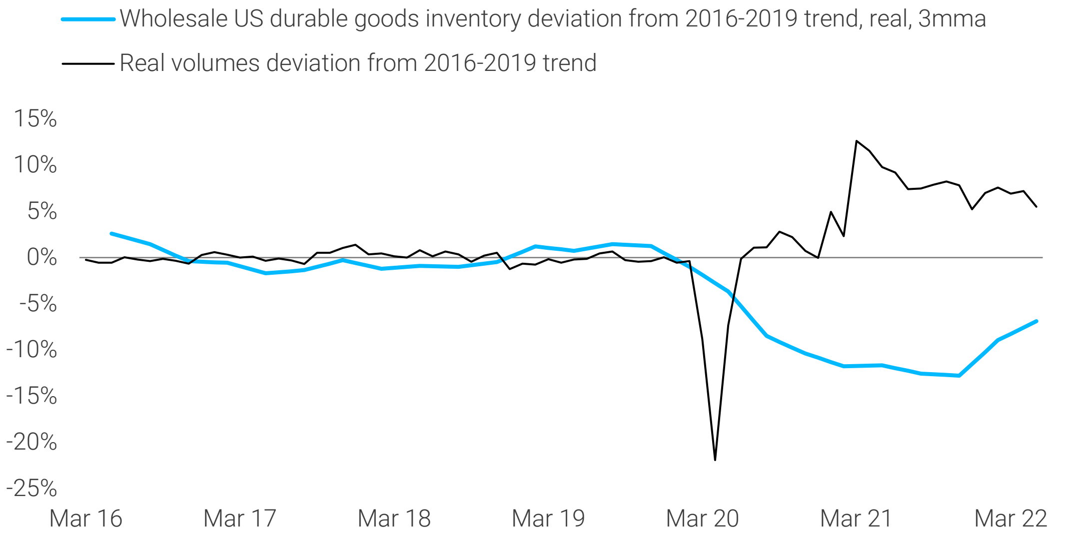
Input cost disinflation should help reduce heat in core goods prices even in the US...



Source: Datastream, TS Lombard.

Nevertheless, the path of core consumer goods inflation in the US remains more open to question. Firms there are likely to have more scope to rebuild margins as input cost inflation retreats, since the underlying supply demand mismatch remains wider, with demand still buoyed by the strong labour market, and legacy of US stimulus excesses in financial wealth. In short, pricing power remains greatest in the US – ultimately to the chagrin of the Fed.

… but the supply-demand mismatch remains large, so output prices will be denied the full benefit



Source: Datastream, TS Lombard.

Implications of disinflation in commodities and goods

The coming disinflation in CPI energy, food and core goods in the US will prove insufficient for inflation to fall below the Fed funds rates that markets expect to be the peak. This leaves the Fed with an unenviable choice. Either turn a "blind eye" to rising unemployment in order to generate sufficient labour market slack to help pull down inflation over time, -- or markets are right about the path of rates, meaning the Fed is unwilling to follow this excess slack "Volcker" path, and thereby leaves demand excessive and, in turn, inflation running well above 2%. While an excessive period of slack is what's needed to return inflation trend to 2% (it can drop to that rate cyclically for a moment or two), the FOMC's actions rather than rhetoric suggest there is more Arthur Burns in their sensitivity to higher unemployment than Paul Volcker.

Any near-term downside risks to our inflation story are likely therefore to manifest in the Fed being more relaxed about cutting rates once these labour market triggers are hit. To reiterate, that policy would run the risk of reinvigorating the credit cycle, at a time when disinflation had just handed back purchasing power to consumers, which all rebuilds inflation further down the line. All in all, US demand seems likely to rebound, thwarting any sustainable reversion of inflation to what will likely soon be the fabled 2%. Uncertainty runs high, and it is possible that the culmination of the disinflationary forces detailed above are enough to drag headlines back to the 2%. But we think this would be a mirage, tricking the Fed into believing the job is done. Read on for the implications of that mistaken belief and how the Fed might react as evidence to the contrary emerges.

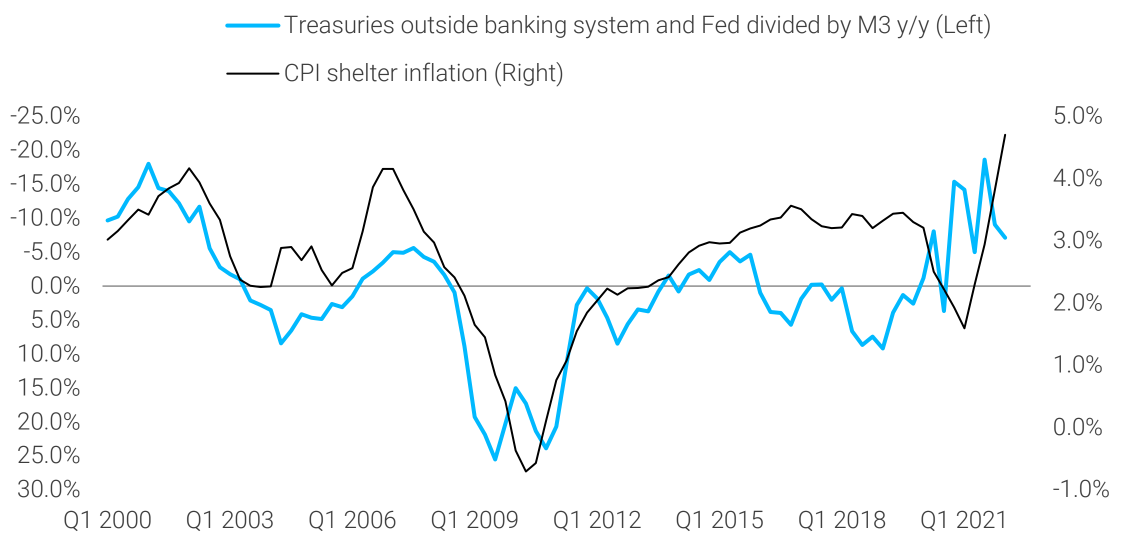
Lingering heat: Services and wage-driven costs (severe for US, significant for EA, non-existent for China)

Labour costs, broadly speaking, are the main driving force of services prices. But the sector is diverse and several components of the basket face other idiosyncratic drivers. In the US case, we have split out shelter and medical care before getting to the direct effects of the leap in wage inflation.

Shelter

Shelter is a catch-all for a diversity of roofs over heads, including lodging away from home, which has recently gone gangbusters as everyone went on vacation at the same time after two years of lack of investment in the sector and labour disruptions. Nevertheless, much of the rise in the component overall can be explained by stimulus effects combined with a genuine shift in the profile of demand, induced by the pandemic: the donut effect, with supply unable immediately to respond.

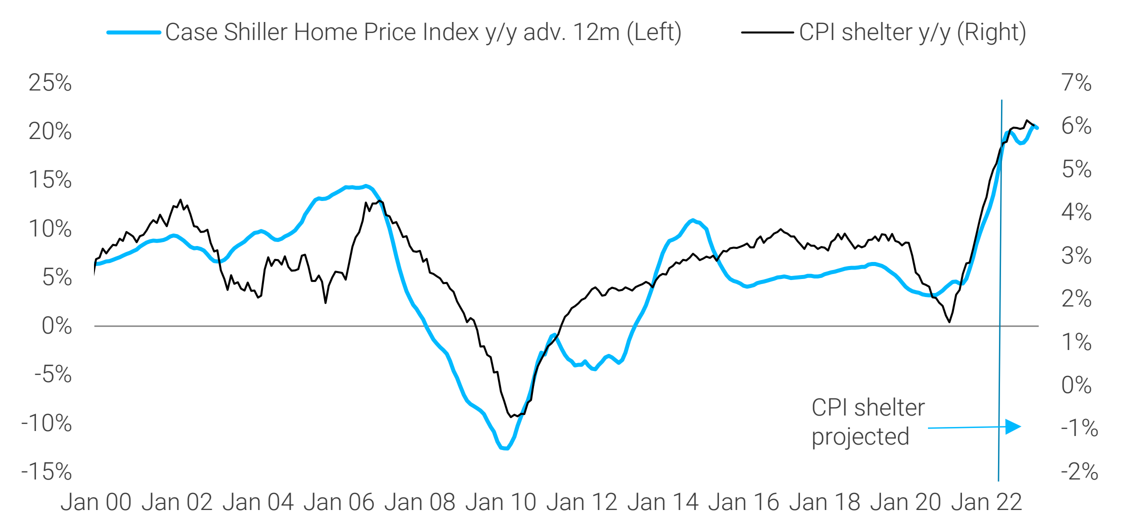
Removing QE from shelter



Sources: Datastream, TS Lombard.

The spike in home prices looks likely to continue to filter into CPI shelter well into 2023. Admittedly, the rapid rise in yields since the start of the year should take the heat out of housing – temporarily. But home prices tend to lead by around 12 months.

US CPI rent inflation is likely to stay high well into 2023



Sources: Datastream, TS Lombard.

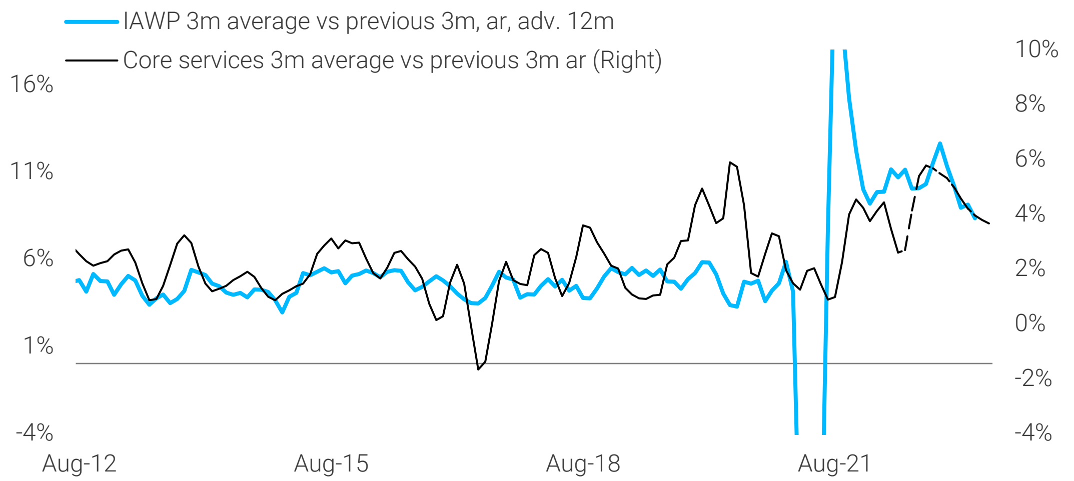
Shelter, therefore, seems likely to continue to contribute upwards of two-tenths of a percentage point to m/m core inflation in the US in the coming months.

Core services (wage driven, with some non-core pressures thrown in as well)

Now we get to the heart of the calculations and the reason why everything else is a mirage. US wage inflation has taken off and, unlike elsewhere, it will take a while to come back down, with demand very overblown next to supply that has still fully to recover. However, progress on this front has now been made.

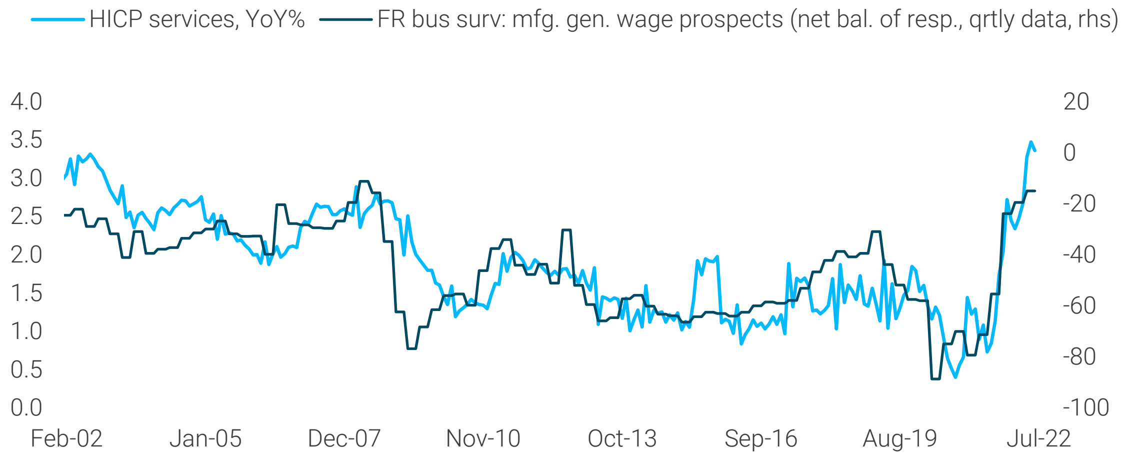
Granted, we see a short-term relationship between average hourly earnings and core services inflation, which could reveal some near-term cooling after growth in the former reached a peak in 3m annualized rates in recent months. But the series is fraught with statistical difficulties and aggregate wage growth remains very strong and has a longer lead on services output price inflation. **The continued upside surprises in core services inflation, therefore, are no coincidence. Wage inflation is driving higher, as the chart below shows.**

The kicker is wage trends in the US



Sources: Datastream, TS Lombard.

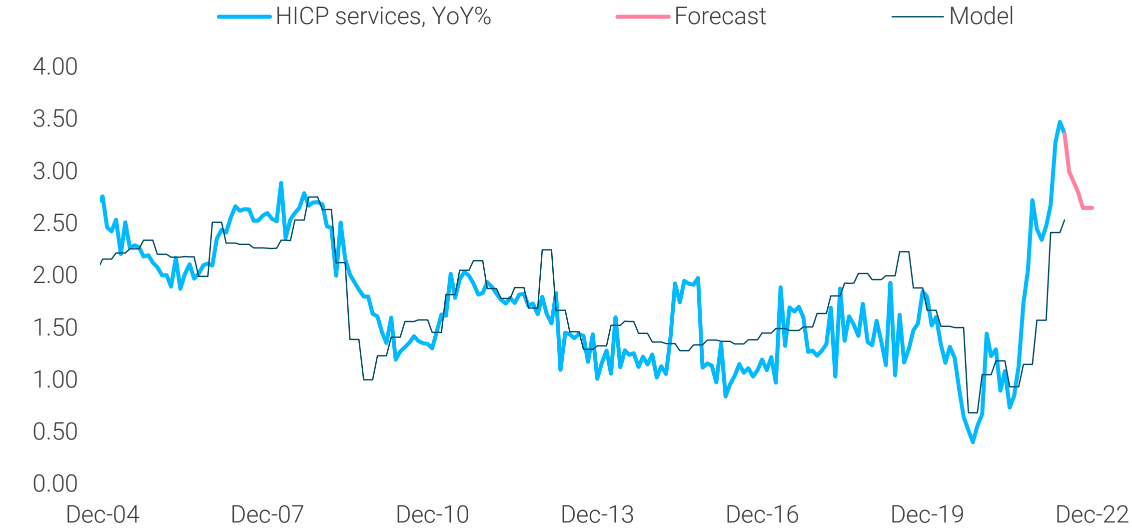
EA wage costs have driven services inflation higher, but recently energy and food have been contributing, too…



Sources: Datastream, TS Lombard.

On the face of it, the EA could look similar. But there are some crucial differences. Wage growth has indeed shot up and services inflation has responded in kind (the best fit we have found is of French businesses on wage prospects. In fact, the most recent rise in services inflation has outstripped the signal from labour costs, probably reflecting the spike in non-core input prices. Wage cost pressure probably has not yet peaked, but in the coming months, the drop in energy and food prices should bring services inflation back into line with the signal from wage inflation.

…which means EA services inflation could drop even before the peak in wage growth



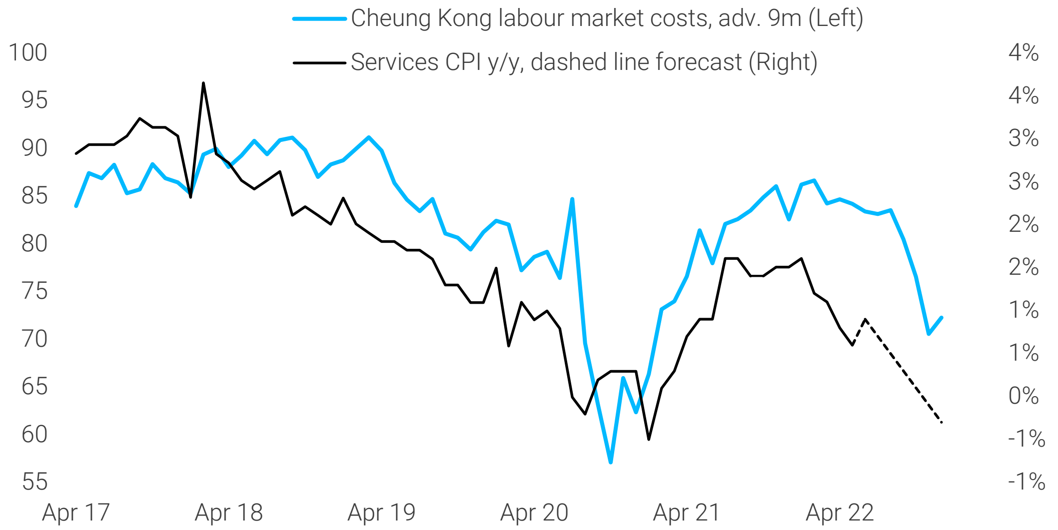
Sources: Datastream, TS Lombard.

More broadly, government measures targeted at capping some prices notwithstanding, a services "revenge summer" implies that pressure on EA core HICP will remain high (remember: services are about 60% of the EA core HICP). The generalized effort to recapitalize businesses after two years of mandated shutdowns and significant supply destruction in some sectors (e.g. the airline industry) is a strong driving force for prolonged heat here. However, once growth starts to slow in earnest and households reassess their finances, opting to hold onto what is left of their saving buffers amid the risks of deteriorating labour markets, we expect services inflation to moderate to around 1.1-1.2% YoY, as businesses reconsider their pricing power. The point (analysed below) is that wage growth is less persistent in the EA, just as the mismatch in labour supply and demand is less than in the US. Nevertheless, going into 2023 we expect services inflation to remain more elevated than in the post-GFC period, as wages growth stabilizes at a relatively higher pace (around 3.5%) than before Covid.

China's labour market story is well head of that of DMs. The PBoC began tightening in May of 2020, almost immediately when the recovery began, and labour demand has not taken the recent lockdowns well. As a result, services inflation peaked mid-way through last year and will continue to come back down, judging by the Cheung Kong labour cost index.

The sting in the tail for China could emerge next year, when we think the authorities will finally have all the moving parts in place to significantly loosen Covid restrictions. After three years of atrophy, the services supply side will have emaciated. And households appear to have added to their savings buffers in the recent lockdowns. So, while there could be a final round of bottleneck/compositional inflation, we think it is unlikely that the PBoC would feel obliged to become more hawkish in response. By that stage, other inflationary pressures will have subsided, and the Fed and the ECB will be mulling a switch to dovishness.

Covid battering of China services means weakening input costs feed straight through



Sources: CEIC, Datastream, TS Lombard.

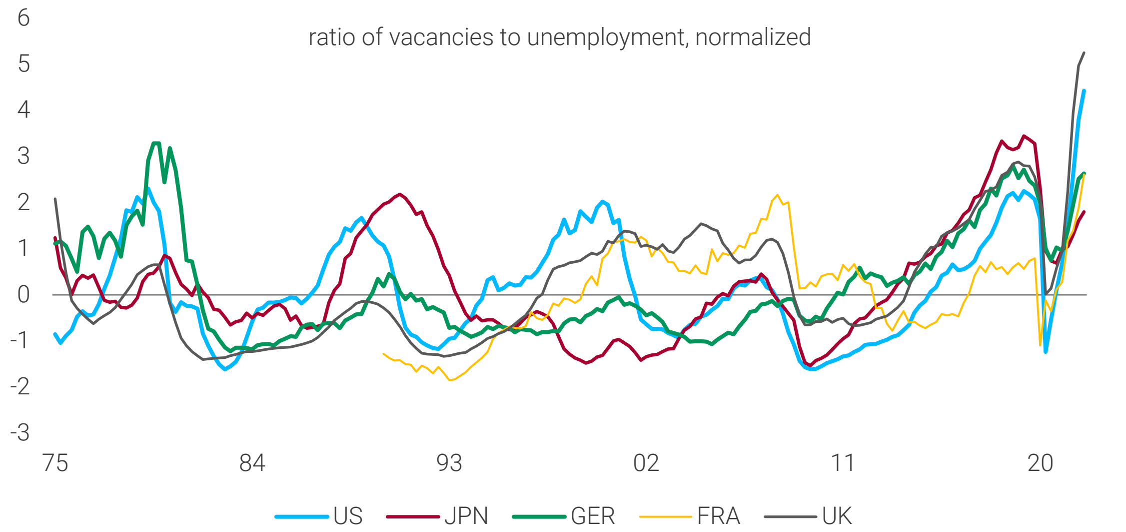
The material point here is that DM labour markets are starting from very tight positions, particularly in the US and the UK. It will take a long time for the labour market to clear in these two countries, with central banks being the only arm of government interested in curtailing demand. Goods disinflation is coming through the pipeline and bringing down not only non-core but also core goods and services to the extent that prices in the sector have been inflated recently beyond what can be explained by wage inflation in the EA, at least.

This disinflation is a mirage for the Fed, as bringing labour demand back in line with supply requires a prolonged period in which real interest rates are held positive. We think FOMC members' terror of being remembered as the ones who let inflation get away will cause them to hang tough and disbelieve the mirage on the way up. But as soon as Fed sees evidence that the labour market is beginning to buckle – which we think will happen by the end of this year – they will begin to be fooled by the disinflation mirage.

The key here is that core inflation on current trends is not likely to end up below 3%, sustainably. If the downside risks to commodity prices and core goods we highlighted above materialize, then the numbers could add up to something that validates expectations of a return to pre-Covid rates. We are forecasting recession, beginning in Q4, so inflation should reach its trough around summer of next year, assuming the Fed blinks. This policy path, however, would allow demand to recover before underlying inflation is hammered back to 2%. Disinflation would give back purchasing power, and credit would begin to take off as rates are cut below inflation. We think the light at the end of the tunnel is that the Fed eventually accepts higher inflation, around 3%, rather than perpetually trying to keep unemployment high enough to squeeze inflation back to 2%. But you will not hear a squeak about that this year.

If the Fed is indeed fooled by the mirage, then the ECB can breathe a sigh of relief. Markets continue to toy with the idea that the ECB will stay on a hawkish path next year, even after the point where markets expect the Fed to begin cutting rates. We think the peak for the Fed is not yet high enough, but when the trigger is released for the Fed to cut, it seems unlikely that the ECB will continue to sound hawkish. The primary concern now is the euro and avoiding further cost-push inflation. But if the Fed halts and reverses, this removes the currency pressure. As the EA is highly likely to be in recession at that point, with the new Transmission Protection Instrument unlikely to prove infallible indefinitely, the GC seems unlikely to press any hawkish points.

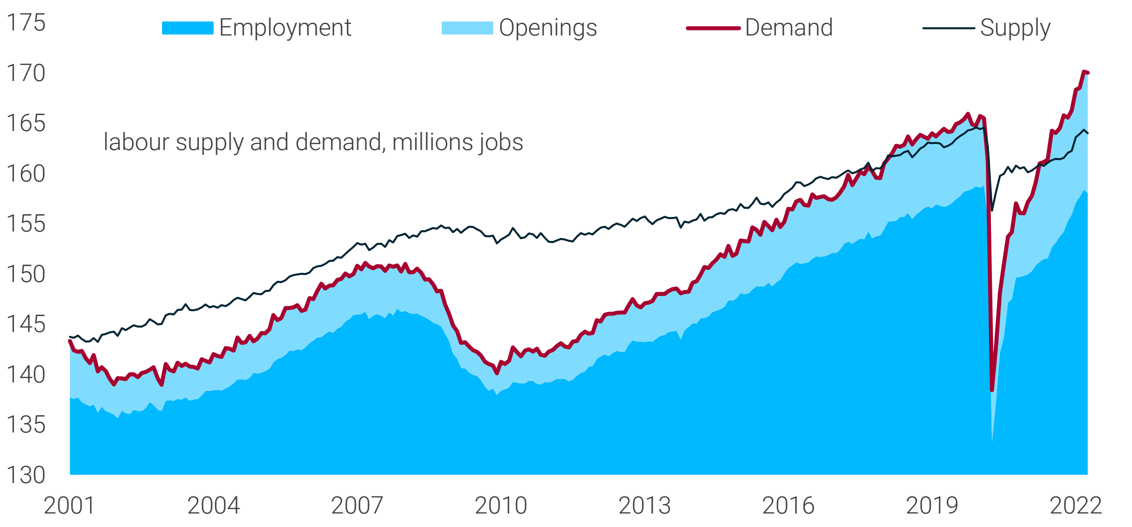
Labour demand-supply mismatch has risen sharply...



Sources: Datastream, TS Lombard.

In the US, the mismatch between demand and supply looks extreme and began to emerge even before Covid. Demand has likely already turned the corner, particularly if high frequency figures from Global Data are proved right. But demand is starting from such elevated levels that it will take a long time for demand and supply to return fully to balance; JOLTS are as much as 1.5 times their pre-Covid peak in November 2018. Supply has now just about recovered to pre-Covid levels, but demand is close to the pre-Covid trend, which is significantly higher.

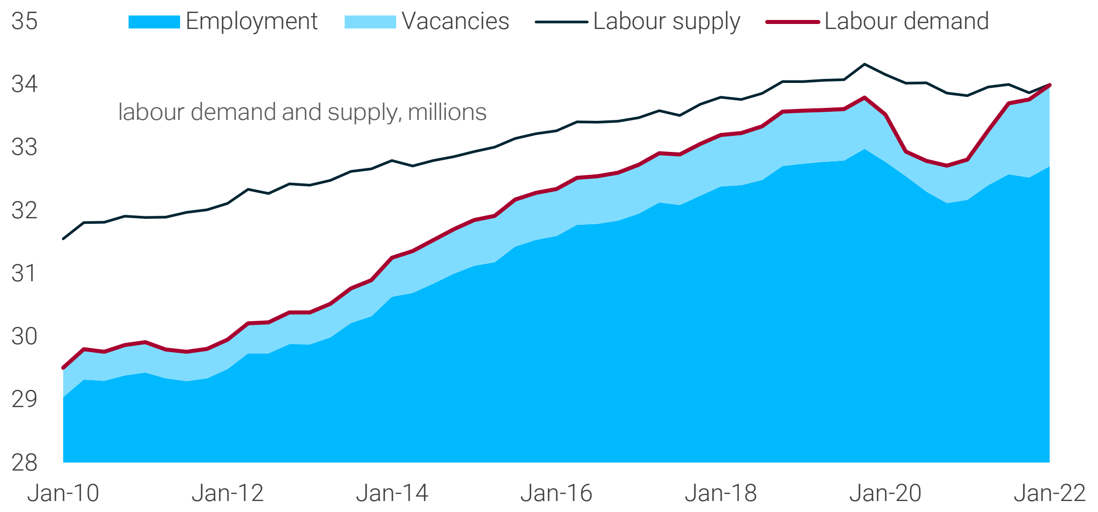
Mismatch in the US labour market is large and has been building for years



Sources: Datastream, TS Lombard.

Labour supply has risen much more slowly in recent years in the UK as well and has not yet quite made it back to pre-Covid levels. By contrast, demand has surpassed 2019 levels.

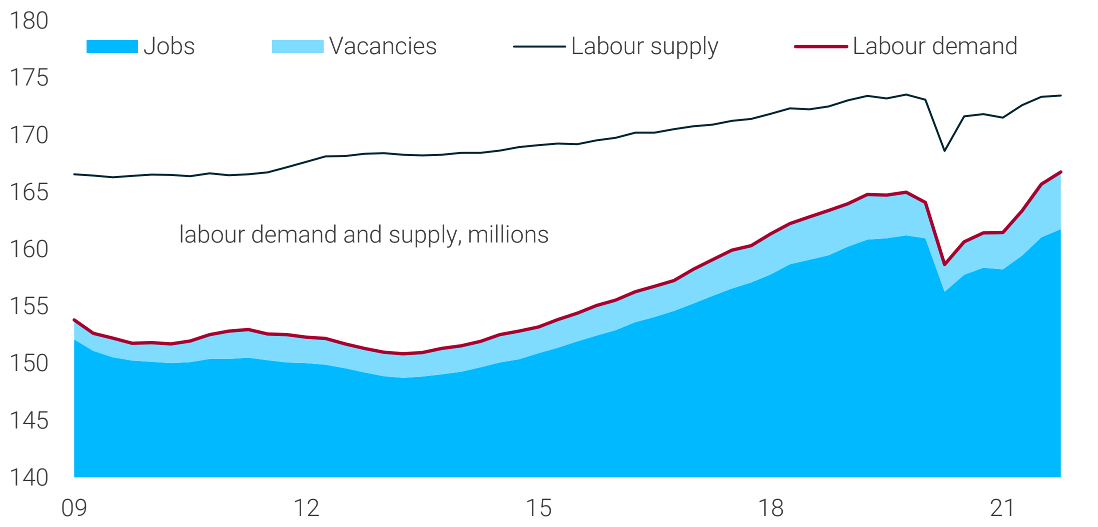
The problem is also intense in the UK



Sources: Datastream, TS Lombard.

The EA jobs market looks rather different. In Germany, the ratio of vacancies to unemployment has reached previous peaks but not surpassed them, as it has done in the US and the UK. Admittedly, the ratio has spiked in France. And labour demand for the EA overall has risen beyond pre-Covid peaks, while supply has only just attained those highs But while slack is less than it was, and there is still a wide pool of workers on which to draw. In the end, we assume that wage growth this year remains at higher rates than in the pre-pandemic era. But we think wage inflation is unlikely to be as sticky as in the US and the UK.

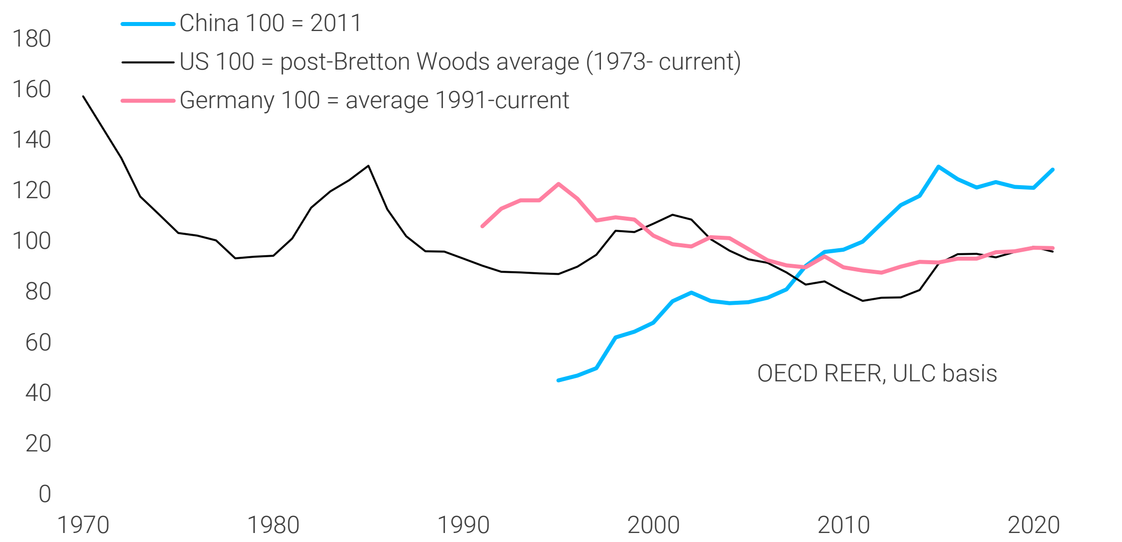
EA labour markets have tightened, albeit not to the same extent



Sources: Datastream, TS Lombard.

Taking a big step back, we notice two things about labour markets that strongly suggest a higher inflation environment was already in the pipeline before Covid, though obviously not as high. First, labour market slack has gradually been eroded, especially in the US and the UK but also in the EA. Second, as this pre-pandemic tightening occurred, wage growth began to test higher ground. We think the RMB has been overvalued since as far back as 2011/12.

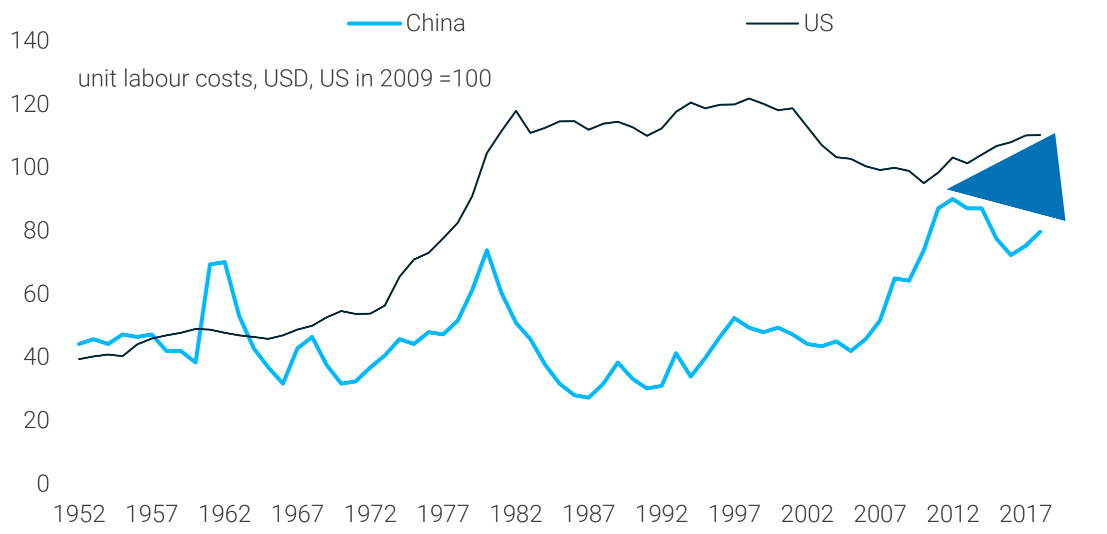
RMB overvaluation has lifted the lid on DM wages…



Sources: OECD, TS Lombard.

The severe reduction of competitiveness in China has removed the limit on DM wage growth. After a few years, the US labour market began to notice what had happened, with unit labour costs rebuilding as China became overvalued; and eventually, Chinese ULCs began to retreat in 2013. This slow-burn change in the global economy implies a form of natural deglobalization, one that has been accelerated by DM policy. This deglobalization goes hand in hand with higher inflation in DMs as frictions are reintroduced into the global economy, meaning that suddenly, domestic output gaps matter once again.

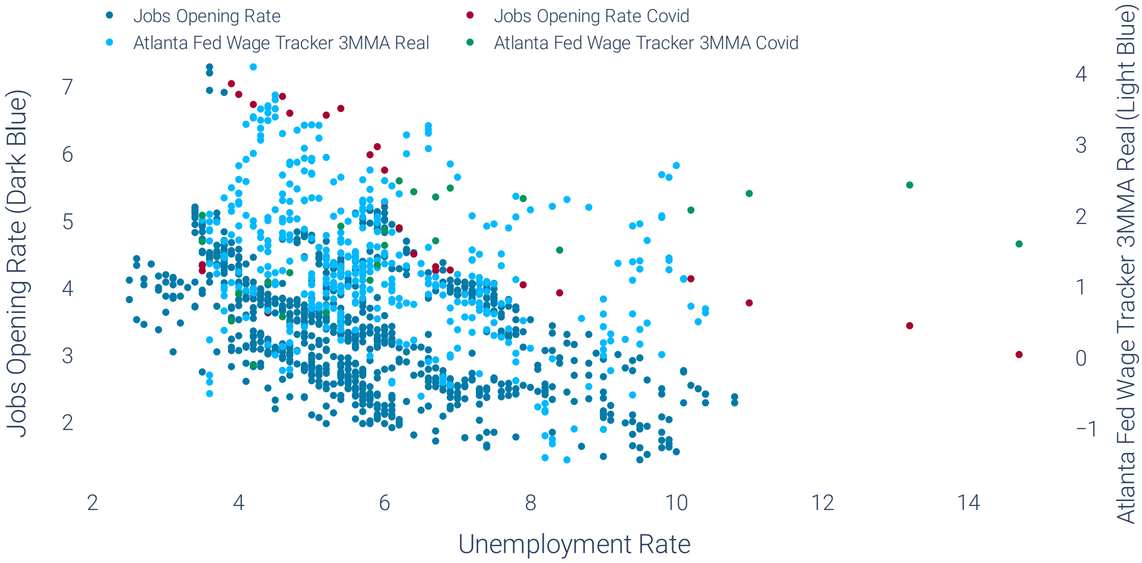
…and US workers noticed this before Covid



Sources: Datastream, TS Lombard.

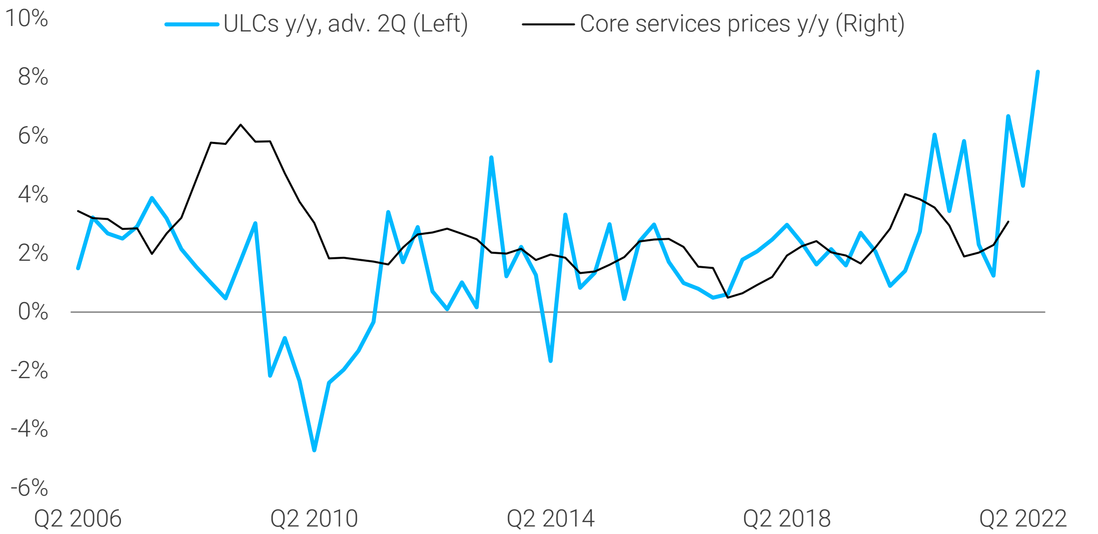
Squeezing wage growth back down to rates consistent with 2% inflation in this environment (and keeping it there) would mean significantly higher unemployment. Ultimately, we think the Fed will be unwilling to accept that trade-off and will accept that inflation needs to be anchored at higher rates.

Keeping inflation at 2% in the US would be painful



Source: U.S. Bureau of Labor Statistics, Federal Reserve Bank of Atlanta

ULC trends have changed



Sources: Datastream, TS Lombard.

Conclusion

Inflation in the major economies is likely to decelerate and could even reach rates that appear to validate expectations of it reverting to pre-Covid trends. For the US and even the EA, this disinflation seems likely to be a mirage. FOMC members are eager to prove they have learned from the experience of the 1970s and will err on the side of caution in the next six months, even as inflation comes back down, taking their cue from the labour market. But once signs of strain appear in employment, the Fed will reverse course.

The ECB, too, is desperate to appear more seventies Bundesbank than seventies Fed. Inflation expectations are fickle, however, and the retreat of inflation in frequently purchased items (food and energy) will bring those expectations back down, assuaging ECB concerns. As recession ensues later in the year and political strife continues to raise questions over the new Transmission Protection Instrument, the GC will be glad of the opportunity to take its foot off the brake when the Fed blinks early next year.

To a large degree, China's ailing property market and difficulty in creating liquidity will dictate how severe the disinflationary mirage becomes. Suggestions that the PBoC will somehow set aside serious financial and growth concerns just because of the rise in pork prices seem out of place. If the strength of the recovery surprises us, we will reconsider; but for now, we believe the PBoC will bide its time, waiting for the Fed and the ECB to return to the dovish side. In the meantime, its main constraint will be depreciation pressure on the RMB (including worries about exacerbating the dollar liquidity squeeze on developers).

The 2020s will be an era in which global trends are dictated by the inflationary tendency of the US and the deflationary bent of China. These trends were at play even before Covid. But the pandemic supercharged the transition, revealing to DM workers that bargaining power is now swinging back in their direction. This eventually means faster growth and inflation, higher yields, a steeper curve and a new lower mean for valuations.

Authors

Freya Beamish
Head of Macro Research

Steven Blitz
Managing Director, Chief US Economist

Davide Oneglia
Economist

Rory Green
Economist, China and South Korea

Konstantinos Venetis
Senior Economist

Dario Perkins
Managing Director, Global Macro

Christopher Granville
Managing Director, EMEA and Global Political Research

Grace Fan
Director, Brazil/Latin America Research