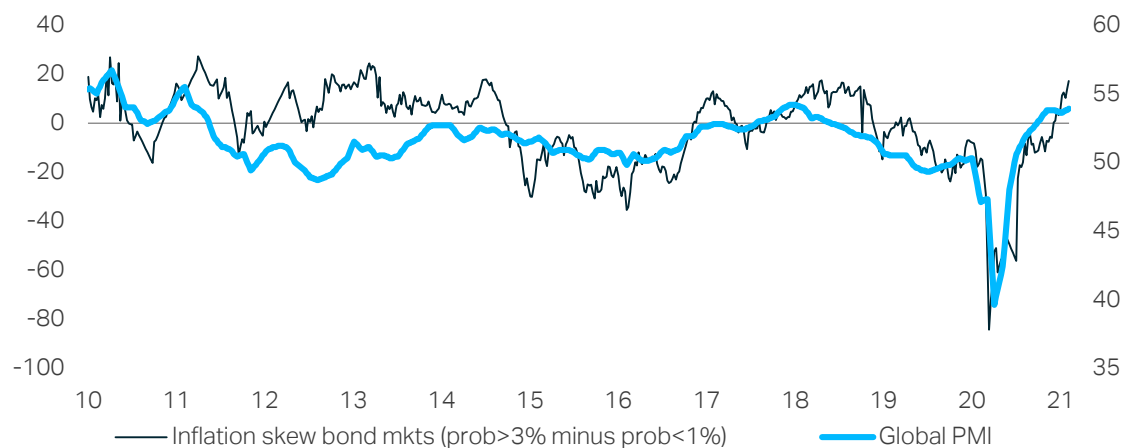


**Macro Picture****"CREDIBILITY TEST"****Dario Perkins**

The combination of a strong industrial recovery and international supply bottlenecks is causing powerful "pipeline" inflation pressures. While central banks will continue to downplay these moves, bond markets have a tendency to over-extrapolate the short-term industrial cycle. This is not necessarily a test for monetary credibility, but it makes exiting QE even more challenging.

Chart 1: Bond markets tend to extrapolate the global industrial cycle

Source: Markit, TS Lombard

COILED SPRING

The global recovery – already underway in the industrial cycle – will gain further momentum over the summer, as lockdowns end. While the improvement will be concentrated in the services sector, manufacturing activity is set to remain extremely buoyant. But the boom period for the global economy could be short-lived, with growth settling back to pre-COVID trends in 2022.

INFLATION BULLWHIP

The powerful recovery in manufacturing and trade, combined with various supply bottlenecks (semi-conductors, shipping, agricultural prices etc.), is adding to "pipeline" inflation pressures. We've been here before, notably in 2009-10 and 2017-18. Central banks will downplay their significance, but these price moves could intensify the inflation scare in financial markets.

POLICY DILEMMA

Pundits like to talk about markets "testing" central-bank credibility. This is an exaggeration, though we could reach a point where the authorities need to respond to rising yields (taking their cue from stock markets). Uncertainty about QE raises more profound credibility issues, especially as the motivation for asset purchases seems fuzzy and there is no clear exit strategy.

**[Book a video meeting with our analysts here](#)**

"CREDIBILITY TEST"

Macro investors spent 2020 discussing the "shape" of the COVID-19 recession, with a particular focus on what this might mean for inflation and monetary policy. Now attention is shifting to the speed and fullness of the recovery. For some countries and industrial sectors, the recovery from the pandemic is already complete. China's economy bounced quickly in 2020, while the resilience of international retail and e-commerce has already produced a powerful revival in global manufacturing. World trade is booming and industrial output is now back to pre-COVID levels of activity. The next phase of the recovery should benefit the biggest economic losers from the pandemic, both internationally and in terms of "sectors". With vaccines looking more effective than anyone dared to imagine 12 months ago (subject, as always, to the risk of further mutations in the virus), hospitalization rates are falling and lockdowns will soon be unnecessary. This will provide a powerful boost to consumer services, particularly hospitality and transport. While these parts of the economy do not lend themselves to "pent-up" demand, they will certainly benefit from post-COVID "YOLO" (You-Only-Live-Once) attitudes. And with an overhang of fiscal stimulus, the recovery in the services sector will not necessarily crowd out those parts of the economy that have been resilient to the pandemic (retail, housing etc.). Instead, we will experience a powerful boom, with the global economy firing on all cylinders.

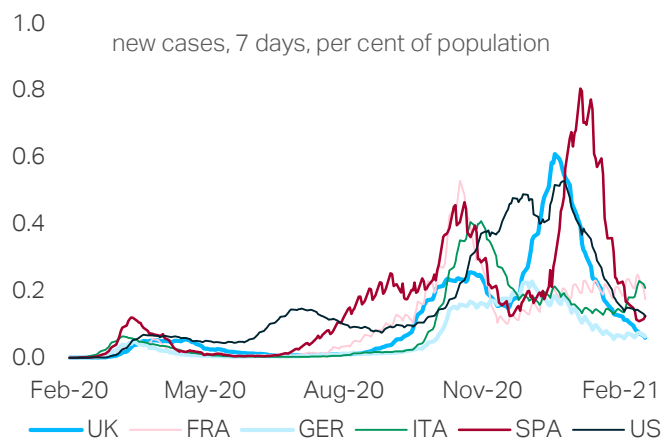
The more difficult question, of course, is about the durability of this economic boom. We suspect it will be short-lived, with growth rates eventually settling back to pre-COVID trends. There will be no "roaring 20s", contrary to the increasingly popular sell-side narrative. The world economy continues to lack secular growth catalysts and the appetite for sustained fiscal expansion might fade more quickly than many investors are assuming. That said, the sheer acceleration in global demand suggests the "reflation" trade has further to run, perhaps becoming an outright inflation scare during the summer. We are already seeing the emergence of acute "pipeline" price pressures, similar to what happened during the recovery from the 2008 financial crisis. Commodities, export prices and shipping costs are rising rapidly, in part due to severe supply disruptions and short-term bottlenecks. There is even evidence of [acute "bullwhip effects"](#), with unusually large swings in global demand creating a considerable amount of stress in international supply chains. These pipeline inflation pressures will feed a recovery in traded goods prices, which together with various distortions in services prices, could create the illusion of a serious inflation outbreak in the coming months. Since bond markets have a tendency to over-extrapolate these sorts of moves, it seems likely that long-term yields will keep rising.

What will central banks do? There is currently a lot of chatter about financial markets "testing the credibility" of policymakers. But this isn't really about credibility – instead, the bond market is beginning to price a different macroeconomic environment to the one the authorities are assuming. Since most central banks are a long way from meeting their objectives and the coming bounce in GDP growth and inflation is likely to prove temporary, we think central banks will retain their uber-dovish stance. Of course, we could reach a point where central banks need to do more. Since it is hard to argue current yields are too high for the real economy, the authorities will take their lead from financial markets. It would probably take a large decline in equities (i.e. more than 10%) and a significant widening in credit spreads to shake the authorities' confidence. The bigger credibility challenge for central banks is about what they plan to do with their massive QE programmes, an issue they will surely need to address by the end of the year. Last spring, policymakers threw everything they had at COVID-19, but the rationale for continued large-scale asset purchases has become increasingly murky. If central banks no longer understand why they are conducting QE, they might also struggle to exit these policies.

1. COILED SPRING

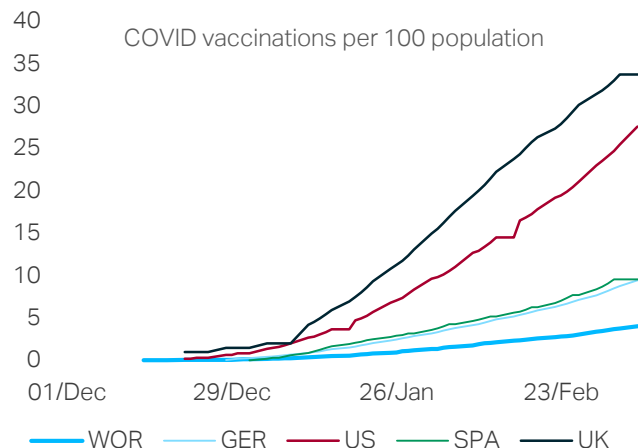
With the pandemic beginning to ease, the economic outlook is suddenly much brighter. Infection rates are down sharply in the US and Europe, while there is clear scientific evidence that vaccines are effective – at least against existing variants of the disease. Data from the UK and Israel suggests mass vaccination campaigns are already having a material impact on hospitalization and mortality rates, which means governments can ease their restrictions on social interaction. Remember, recent lockdowns were not designed to eradicate COVID – most scientists think this is impossible – but rather to prevent health services from being overrun. Vaccines now provide an alternative, less economically damaging way to achieve the same outcome. Unfortunately, not all parts of the world have made as much progress with vaccine rollout as the UK and the US, but warmer spring/summer weather provides a window of opportunity for these countries (especially in the EU) to catch up. The world economy is set for a powerful recovery during the second half of 2021, which – assuming there are no nasty mutations in the virus during the autumn/winter – should carry over into the first half of 2022.

Chart 2: The end of the pandemic?



Source: Datastream

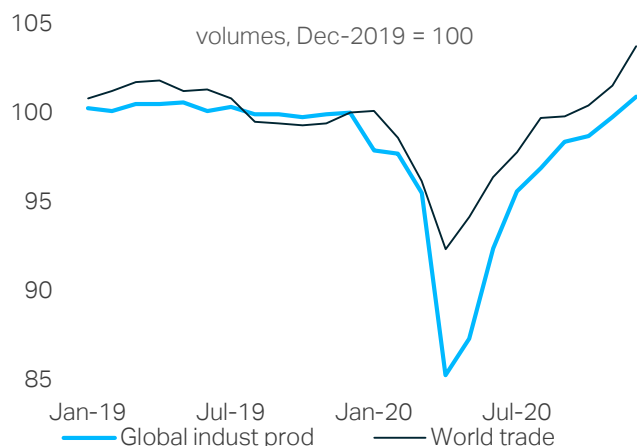
Chart 3: Uneven vaccination distribution



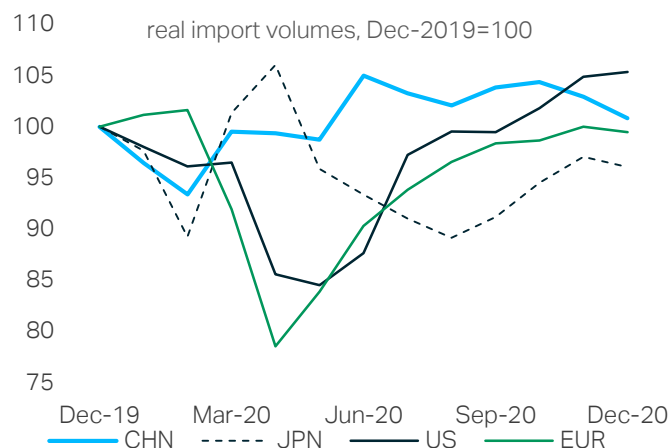
Source: Datastream, TS Lombard

Industrial recovery complete

At the global level, the economic recovery has already been underway for some time – though it has been hugely uneven across different countries and sectors. China, which emerged first from the pandemic, had already returned to pre-COVID GDP levels by the end of 2020 (though the economy still had a large shortfall in output compared to what the authorities were expecting 12 months earlier). China did well not only because it was able to suppress the disease more effectively but also because its large manufacturing sector enjoyed strong international demand for consumer goods, especially from e-commerce. American and European consumers couldn't engage in some forms of activity – those that relied on social interaction – so they substituted their spending for manufactured goods instead, especially those they could still consume while in lockdown (e.g. tech). Western retail sales recovered quickly, which pushed global industrial output and world trade promptly back to pre-pandemic levels. Charts 4 and 5 show a V-shaped recovery in the industrial cycle, even as consumer services remained depressed.

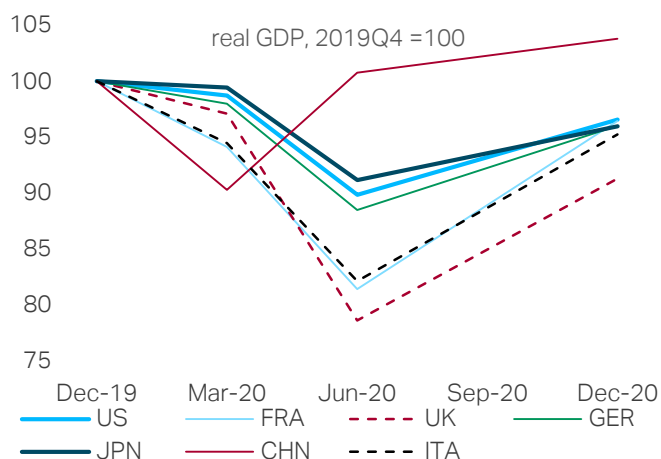
Chart 4: The industrial recovery


Source: CPB World Trade Monitor, TS Lombard

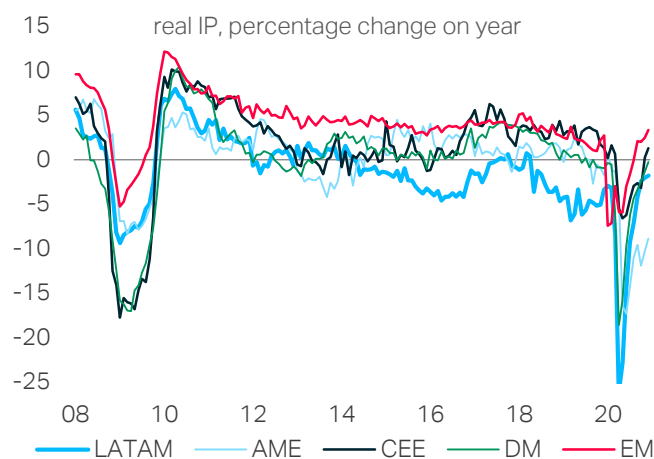
Chart 5: Regional trade revival


Source: CPB World Trade Monitor, TS Lombard

The revival in global manufacturing continued through the winter, despite the second-wave of the pandemic, which saw most European governments put their citizens back into lockdown. It helped, of course, that Lockdown II was generally less stringent than Lockdown I, with – for example – most European factories and retail outlets remaining open. This meant the economic damage from the virus became more narrowly concentrated in hospitality, tourism and travel. Charts 8 and 9 show French and UK GDP were surprisingly resilient in the final months of 2020, though activity surely deteriorated further at the start of 2021. The US economy did even better, continuing to recover – albeit at a more gradual pace – from its pandemic lows. Though the United States has matched the UK's COVID-19 infection rates since late-2020, it did this without the country's hospitals becoming overrun or the economy going back into total lockdown.

Chart 6: Uneven 2020 growth patterns


Source: National sources, TS Lombard

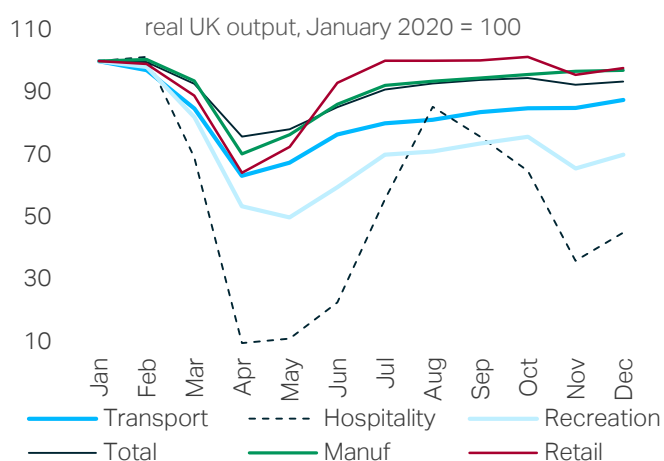
Chart 7: V-shaped industrial cycle


Source: CPB, TS Lombard

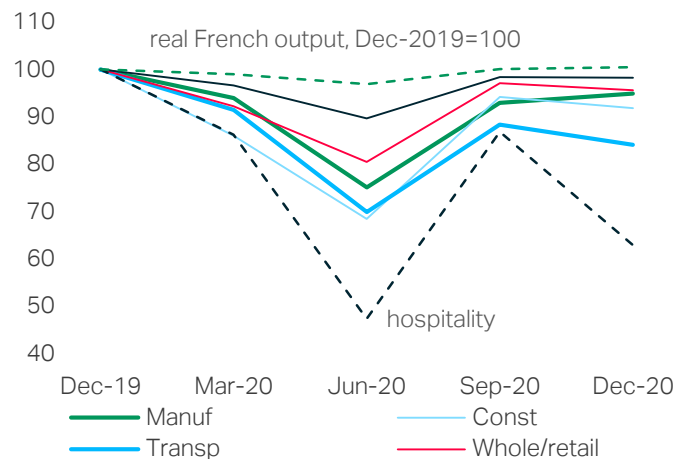
The Great Unlocking

Those sectors – and countries – that have struggled most during the pandemic will surely be the main beneficiaries from post-COVID recovery. The hospitality, transport and consumer services sectors will experience a powerful revival, with activity set to recover to where it was before the crisis. Since these sectors were responsible for most of the job losses in 2020, this will generate a substantial improvement in labour markets (while providing a boost to public finances,

especially in countries that have been running expensive furlough schemes). More generally, we should expect the easing of lockdowns to unleash some pent-up demand, the so-called “YOLO” (You Only Live Once) economy. Government support measures have produced an overhang of fiscal stimulus in most economies (especially the US), which has [shielded private-sector balance sheets from the crisis](#), even producing an “excess” level of housing savings. While we think some commentators are exaggerating the magnitude of this consumer boom – as we explained in [our previous Macro Picture](#), much of the saving is concentrated among the wealthiest citizens, who are less inclined to spend – it is clear the world is set for a powerful economic recovery in H2.

Chart 8: Second-wave more concentrated?


Source: Datastream, TS Lombard

Chart 9: The W shaped downturn


Source: Datastream, TS Lombard

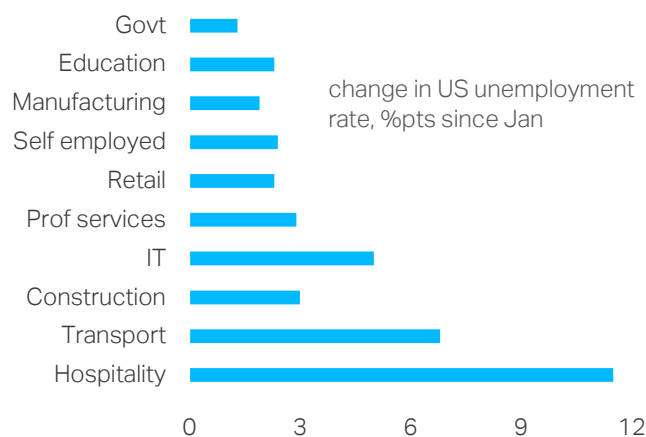
Industrial support

While the next phase of the recovery will favour services activity over manufacturing, world trade and industrial activity are likely to remain extremely buoyant. There may not be a great deal of pent up demand in retail or consumer goods, but the savings households have accumulated means they will not need to cut these areas to spend more on hospitality, travel etc. At the same time, reduced uncertainty about the macro outlook should encourage businesses to increase their capital spending, which will provide a further boost to the global industrial cycle. In short, the world economy will soon be “firing on all cylinders”, with a synchronized boom both internationally and across multiple sectors. Even if this recovery isn’t going to transform the secular macroeconomic outlook – this is not the start of a new “Roaring 20s” regime – it can only intensify the “reflation” narrative, which already has a firm hold over global financial markets.

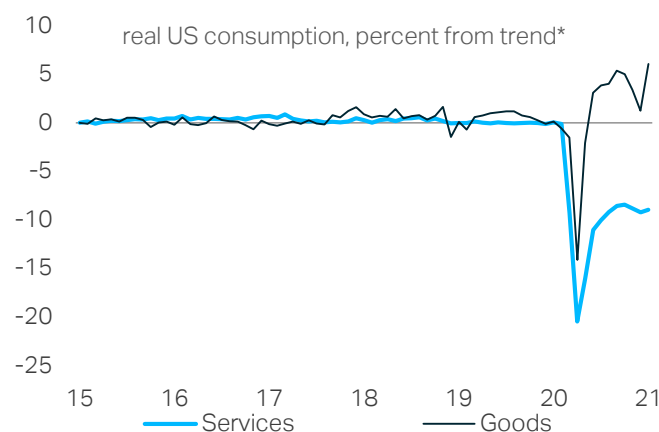
What about “scarring”?

We do not yet have any clarity about the economic scarring from COVID-19, which will only become clear once the pandemic is over. Governments seem to have done a good job shielding private-sector balance sheets – preventing financial scarring (especially in the US) – but we are likely to emerge from this crisis with higher levels of unemployment. US data, for example, show joblessness has increased in every subsector of the economy – on average by around 2% pts – which suggests it will take time for the labour market to heal. Participation rates are also down sharply. The situation in Europe is murkier, with a large proportion of the labour force in official furlough programmes (20% in the UK). We do not know if all these workers will still have jobs once governments remove this support– it is possible they will look to secure new efficiency gains by trimming their workforce. The degree of labour-market scarring probably doesn’t matter for financial markets – which focus on the rate of improvement in the economy – but it will

crucial for the fiscal and monetary-policy outlook. Central banks, in particular, are determined to get back to pre-COVID employment rates and will stay dovish if unemployment remains high.

Chart 10: Some labour-market scarring?


Source: BLS, TS Lombard

Chart 11: Pent-up services demand


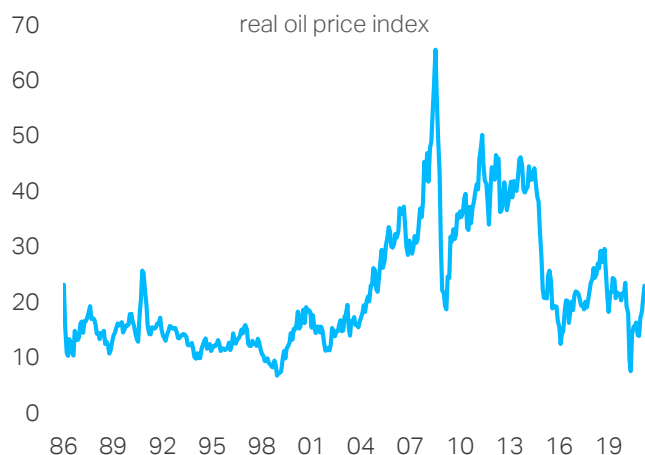
Source: BEA, TS Lombard, trend is 2015-2019 growth rates

2. INFLATION BULLWHIP

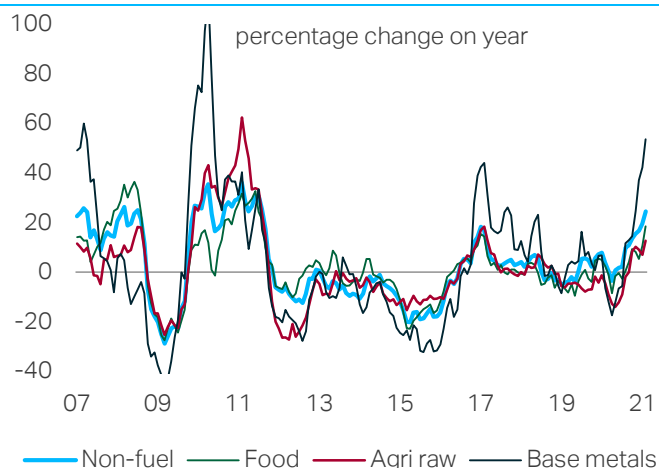
The prospect of a strong global recovery has already had a powerful impact on bond markets, with US yields rising by 100 basis points from their lows. For the most part, the authorities will welcome this move, especially as it is the unwinding of a massive deflation skew. According to the Minneapolis Fed, last summer the bond market was pricing a 60% chance of inflation dropping below 1% in 5 years' time. Today, that probability is less than 10%. The move is also a sign markets have understood the Fed's new strategy. Since inflation expectations have rebounded faster than nominal yields, real rates have plunged. This suggests the [Average Inflation Target](#) is "working". Yet central banks will not want to see inflation expectations rise too far, especially if this begins to have a clearer impact on nominal bond yields. And there have recently been signs that such a dynamic is emerging, with the reflation narrative starting to resemble an outright inflation scare. We suspect this anxiety about the inflation outlook will get worse, especially as "pipeline" price pressures have started to emerge in the industrial cycle.

Pipeline pressures

It was always inevitable that the strong industrial revival would lift commodity and traded goods prices. As with the deflation/inflation skew in bond markets, this is mainly the unwinding of what happened a year ago – when the shutdown of the global economy caused prices to collapse. It wasn't long ago, for example, that nobody wanted to take physical ownership of oil, which caused short-term futures to trade at negative prices. Commodity prices in general have always

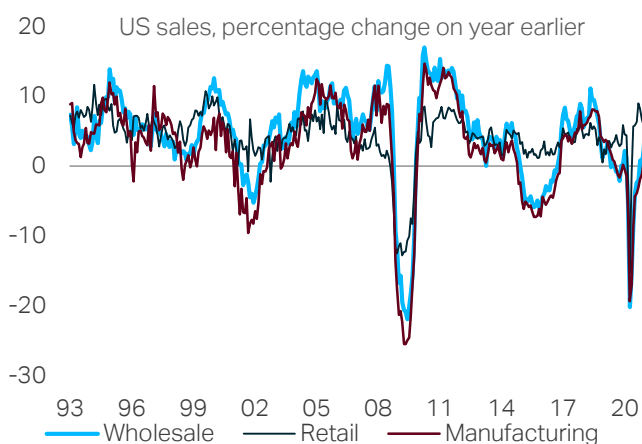
Chart 12: Bounce in oil prices


Source: Datastream, TS Lombard

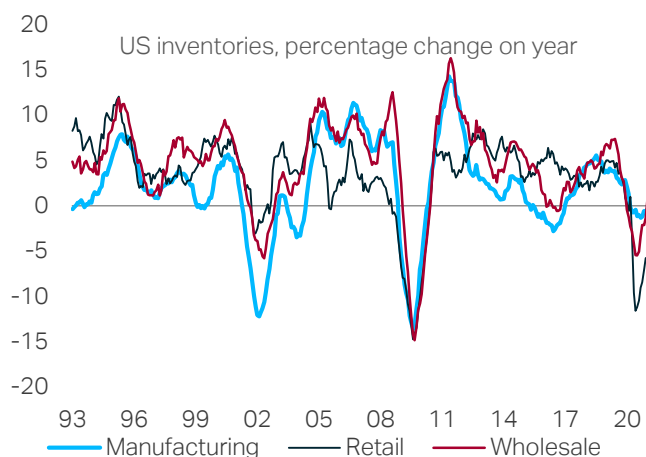
Chart 13: All commodities now booming


Source: IMF World Commodity database

been highly cyclical, especially those that are a derivative of energy demand. Yet it is also clear that short-term supply pressures have compounded this rebound in prices, thanks to a variety of production bottlenecks and supply-chain stresses. These issues are particularly visible in the international shipping industry, where the price of moving freight between China and the US/Europe has surged. Not only has demand recovered quickly, but the pandemic has created its own set of issues, by disrupting shipping patterns and slowing down the loading/unloading of cargo in major ports (due, for example, to new social-distancing restrictions). And we see similar issues in a range of other industries, with supply bottlenecks in agriculture, chemicals, metals, wood, food distribution, electronics (especially semi-conductors) and the automobile industry. Recent PMI data (and the comments from businesses who responded to the survey) highlight acute supply-chain pressures and extended delivery times throughout the developed world.

Chart 14: Bullwhip effects along supply chains


Source: BEA, TS Lombard

Chart 15: Retailers will rebuild inventories?


Source: BEA, TS Lombard

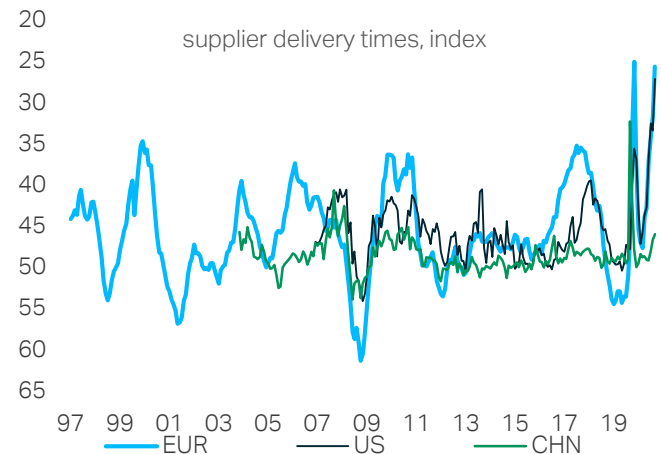
Bullwhip effect

There is no doubt COVID-19 has created a unique set of problems for international supply chains. Yet some of what we are seeing is part of a more general phenomenon – the “bullwhip effect” – where large swings in demand always create problems for “upstream” producers. Something similar happened during the 2008 subprime crisis. But, of course, the magnitude of

the demand shifts that have taken place during the pandemic go far beyond anything we have seen before –the largest contraction and recovery in global GDP for at least 300 years. The bullwhip effect has been well-documented in corporate logistics, capturing the tendency for supply chains to amplify output/order variation at every subsequent upstream echelon of activity, from retailers to wholesalers, and from wholesalers to manufacturers and primary industries. Procter & Gamble [first coined the term in the 1990s](#) to refer to the amplification of order variance they observed with its own suppliers. Since then, a vast academic literature has evolved, documenting similar patterns in almost every industry ([see Wang and Disney \(2015\)](#)).

Chart 16: Surge in global shipping costs


Source: Datastream

Chart 17: Acute supply-chain pressures


Source: Markit PMI, TS Lombard

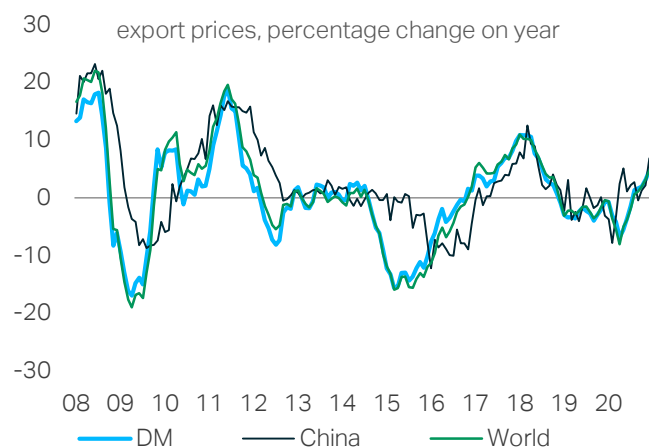
Economists and logistics experts have suggested a variety of mechanisms that could explain the bullwhip effect, including bulk ordering, price discounting, rationing, “shortage gaming” and uncertainty about future demand. But perhaps it is just a general trait of complex systems, where individual companies overreact and this gets multiplied up. If, for example, demand suddenly increased by 10%, retail companies might worry about running out of inventory, so they order extra from their suppliers, opting for e.g. 15% more (to be on the safe side). That supplier, in turn, might order more from their suppliers – this time increasing the quantity to, say, 20%. So the size of the order is amplified along the supply chain, in this case doubling the initial increase in demand. In the early phase of COVID-19, there was also evidence of “shortage gaming”. This describes how, when there is a shortage of a particular product, downstream businesses will inflate their supply needs artificially, in an attempt to secure a greater share of the resource.

Just-in-case over just-in-time?

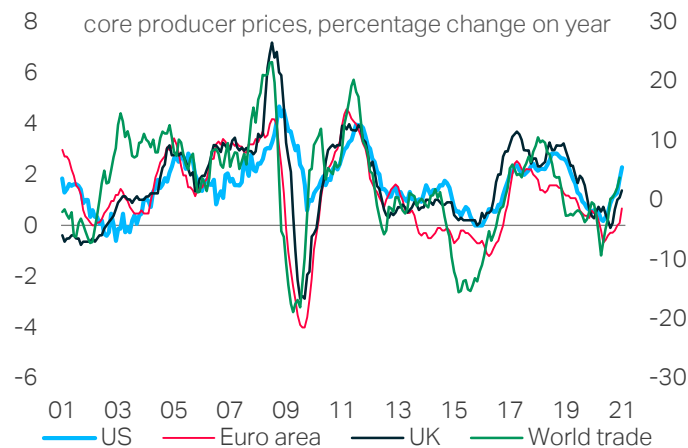
We might expect the bullwhip effect to have become weaker over time. Research by [McMahon and Wanengkirtvo \(2013\)](#) found that order variability in the durable goods industries had declined by around 40-50% since the 1980s. Companies have certainly [learned to manage their supply chains better](#), thanks to new technologies, automation and digital information. But companies also prioritized cost efficiencies over resilience, with supply chains becoming longer and more complex, leaving them vulnerable to disruption. [COVID-19 has exposed the vulnerabilities of this system](#). The best example of this is what is now happening in the auto industry, where many manufacturers have had to halt their production of cars because they cannot secure enough semiconductors¹. Over time, this experience could lead to a major

¹ The shortage of semi-conductors has been [a big theme in global financial commentary in 2021](#). The immediate problem was caused by auto manufacturers cancelling orders during lockdowns (because they underestimated

rethink in the way large manufacturers source their inputs, by reducing the complexity of their supply chains or securing multiple suppliers. It might accelerate international “reshoring”, or create a new era in which “just-in-case” procurement replaces the existing “just-in-time” regime.

Chart 18: Export prices highly cyclical


Source: CPB, TS Lombard

Chart 19: Pipeline inflation pressures


Source: CPB, TS Lombard

What does this mean for inflation?

While there is a chance production costs will be permanently higher in the post-COVID era, the acute pressures we are seeing today are likely to be temporary. Production bottlenecks and disruption will ease, supply will adjust, and the Bullwhip effect will fade. We think these pressures are akin to “speed limit” effects, which tend to cause a temporary acceleration in prices, rather than push us into a new high-inflation regime. As we explained in our previous Macro Picture, we do not believe the world is facing a serious risk of “overheating” – especially as we will emerge from COVID-19 with higher levels of unemployment. But for financial markets currently obsessed with inflation risks, the further acceleration in global goods prices can only intensify the narrative about a “new regime”. In fact, bond markets have always been overly sensitive to the global industrial cycle, a pattern we saw repeated throughout the 2010s. Every time global industrial demand increased and producer prices accelerated, investors become obsessed with inflation risk and central bank “exit strategies”. Industrial slowdowns, in contrast, gave us several deflation scares and widespread anxiety about monetary policy “running out of ammo”.

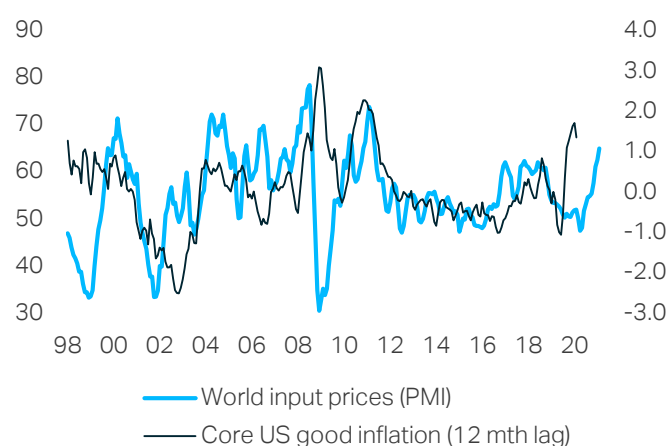
2009-10 redux? Not for central banks...

To some extent, the pipeline inflation pressures we see today are an exaggerated version of what happened in 2009-10. Back then, oil and commodity prices bounced back from their recessionary lows and international trade recovered, boosting export prices and lifting core producer inflation. Financial markets began to worry about a sustained inflation outbreak and some central banks even tried to normalize monetary policy more quickly, a decision they would quickly regret – especially in the case of the ECB, which found itself hiking interest rates into a banking crisis. This time, however, central banks are determined to avoid similar mistakes.

demand) and chip producers reallocating their supplies elsewhere, especially to sectors that enjoyed buoyant demand throughout the pandemic. Across the board, there is asymmetry and supply issues. Automakers have a shortage of chips and chipmakers have a shortage of machines to make them. A chip can take up to 3 months but a machine takes a lot longer to manufacture. But the crisis has also highlighted long-term issues for the global economy, which we have discussed in other research (see here for a Daily Note on how semi-conductors have become the “new oil”, a global supply constraint and the source of a critical geopolitical battle).

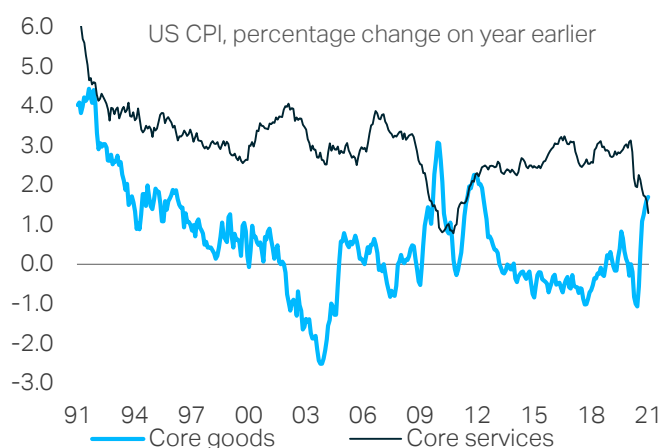
Chart 20: Industrial cycle drives 5Y5Y inflation


Source: Markit, FRED database

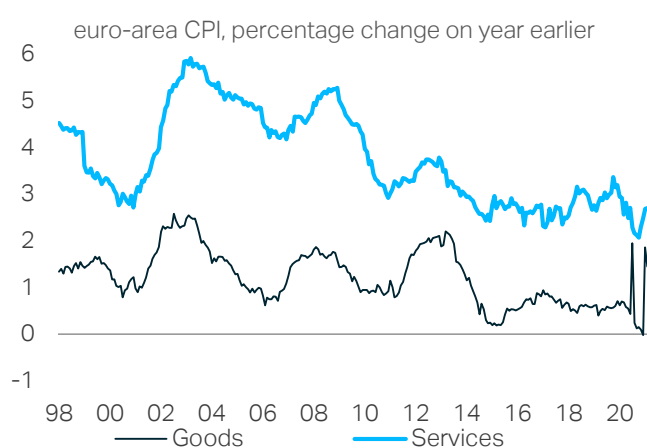
Chart 21: Core US goods usually lag


Source: Markit, BLS

Monetary policy seems to have learned the lessons of the last decade. The authorities are now putting more weight on broader policy objectives, especially those related to the labour market, where they would like to see a complete recovery before tightening policy. But the coming spike in inflation is unhelpful, especially as there are reasons to think it will look scarier than what happened immediately after the global financial crisis. Back in 2010-11 there was a slowdown in domestically-generated services inflation, which comfortably offset the acceleration in global goods prices, keeping underlying inflation trends down. This time, since COVID-19 distortions caused services prices to plunge last year, these “base effects” will soon drop out, which means both goods and services inflation will rise together. Central banks face a tricky environment of white-hot growth and potentially the illusion of a broad-based inflation revival. Is it any wonder markets a beginning to question whether their authorities can retain their uber-dovishness?

Chart 22: This inflation scare will look nastier?


Source: US data from Datastream, TS Lombard

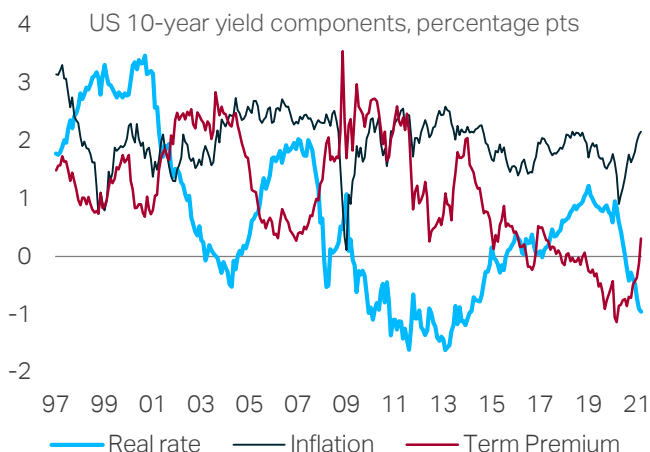
Chart 23: EA goods and services move together


Source: Euro area data from Datastream, TS Lombard

3. POLICY DILEMMA

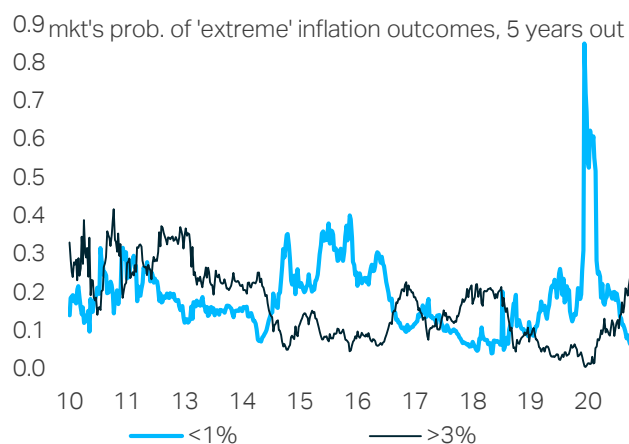
There is a lot of chatter in financial markets about the “credibility challenge” central banks are facing. Bond markets, they claim, are starting to “test” the authorities’ resolve. If this is true, then this challenge is only going to get trickier over the next six months. Yet it is important to remember that this isn’t really a credibility issue. Central banks are setting monetary policy based on a particular view of how they think the economy will evolve. They know growth will rebound strongly in H2 but they don’t believe this will immediately resolve the current economic crisis. They think COVID-19 will leave persistent scars – especially in labour markets. This is also why they think any rise in consumer prices will be temporary, with inflation eventually settling back below their 2% targets. The issue for bond markets is not whether central banks are telling the truth about their reaction function – how they respond to these conditions – but whether officials are making the right assessment about the economy’s evolution. If rising yields, for example, were a sign that markets were expecting a faster recovery from COVID-19, this is something the authorities would welcome. It would not mean they have “lost credibility”.

Chart 24: Decomposition of US yield move



Source: Datastream, NY Fed term premium, TS Lombard

Chart 25: Inflation risk takes over



Source: Minneapolis Fed, TS Lombard

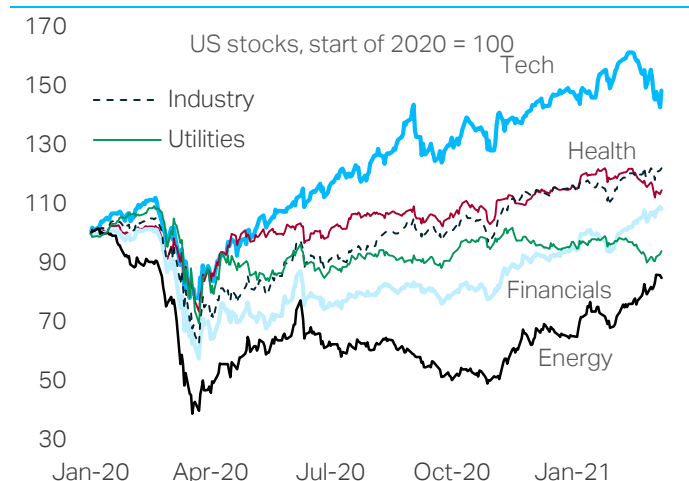
Don't fight the bond market?

To the extent the bond market is taking a more optimistic view about the secular growth/inflation story, we should not expect central banks to fight this. Instead, they will simply reiterate their own assessment of the economic outlook and why this means they are retaining their uber-dovish policy guidance. If the economy recovers faster than they expected, higher bond yields will have been a sign of economic strength, rather than a cause for concern. Things would become more interesting, however, if the authorities started to believe that rising bond yields were actually a threat to the recovery. But how will central banks know when they have reached this point? Right now, there are important differences across countries. While the Federal Reserve seems prepared to tolerate higher long-term interest rates – especially if they reflect a larger fiscal stimulus and the impact of the vaccines – this is not the case for the ECB. The European fiscal response has been weaker, there is more evidence of economic scarring, and the vaccine rollout has been underwhelming in the EU. In these circumstances, keeping yields low is more of a priority for the ECB, which is why it seems to be edging towards an implicit yield cap.

Equity vigilantes

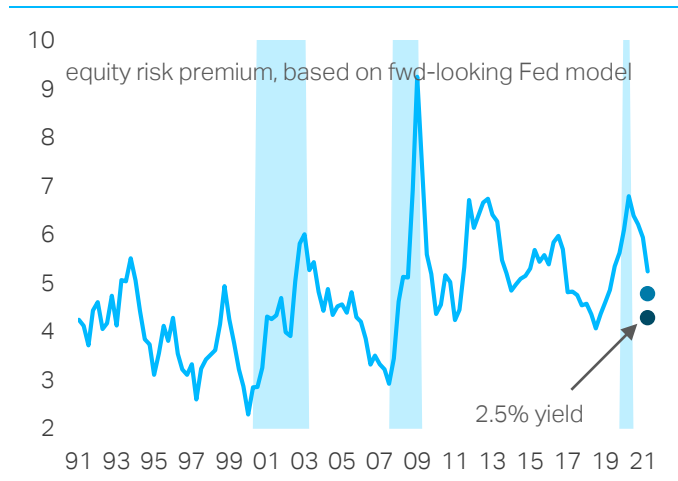
In reality, it is hard for central banks to judge whether bond yields are “too high”, especially if the economy is on the path to recovery. They are likely to take their lead from broader financial conditions, especially credit spreads and equities. This makes sense because the financial sector is surely more vulnerable to rising interest rates than the real economy, particularly at this stage of the reopening process. We doubt the Federal Reserve, for example, will become overly concerned about the selloff in bonds unless it were to trigger a significant (i.e. more than 10%) decline in the US stock market or a deterioration in corporate credit. Only then would it be forced to strengthen its forward guidance, either by providing a definite timeline to its QE programme, or by introducing some form of cap on yields. How likely is such a tightening in financial conditions? There are certainly parts of the stock market that look vulnerable to the higher discount rate, especially “growth” sectors such as tech companies that had “rerated” on the basis of perma-zero interest rates. Yet other sectors are less sensitive and will benefit from stronger revenues as the pandemic ends. So a “rotation” in equities could prevent a sharp decline in the overall index (as has been the case so far). A simple discount model suggests it would take a rise in yields to around 2-2.5% before the overall risk premium looked troubling.

Chart 26: The beautiful rotation



Source: Datastream, TS Lombard

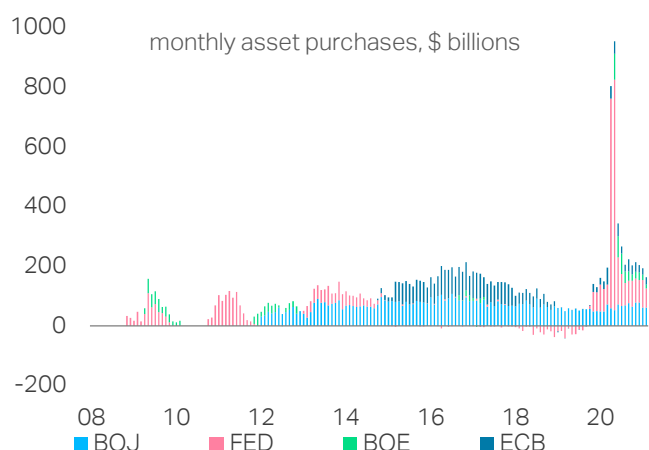
Chart 27: Yields can rise to 2-2.5%?



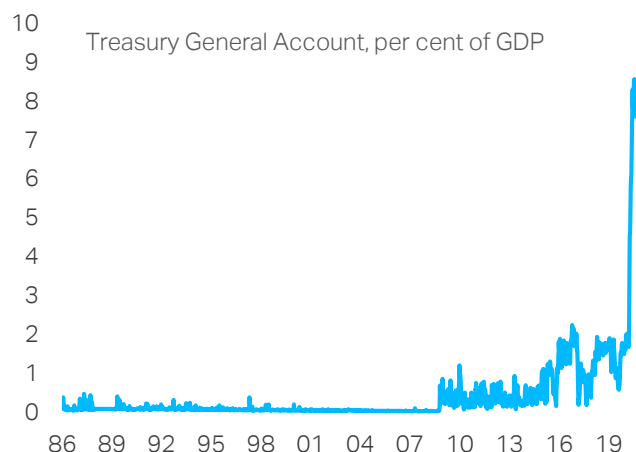
Source: TS Lombard based on Shiller CAPE

The QE mystery

While the selloff in bonds is not necessarily a test for central banks – especially those without explicit or implicit yield caps – the bigger credibility question is about what they plan to do with their QE programmes. In contrast to their interest-rate guidance, the monetary authorities have not provided a clear exit strategy for their asset-purchase programmes. Worse, it is not entirely clear if the authorities really understand why they are even engaged in QE, let alone how they intend to adjust these policies in the future. Paul Tucker, the former Deputy Governor of the Bank of England, [explored this issue in detail in his recent testimony to the UK Parliament](#). He argued central banks no longer had an underlying QE “strategy” because they had simply thrown everything they had at financial markets during last year’s crisis, without any clear idea about what this was intended to achieve. Did they do this because the economy needed additional monetary stimulus, or were they trying to provide a backstop for global markets (especially non-bank credit and shadow banking)? Was the objective to get emergency cash to governments quickly, or have central banks been trying to keep public-sector borrowing costs down?

Chart 28: Massive QE purchases


Source: National sources, TS Lombard

Chart 29: US bank reserves to swell further


Source: FRED, TS Lombard

Plumbing worries

If the authorities do not really understand why they have been doing QE – other than it was the only thing they could really do over the past 12 months – then they might struggle to exit these policies. Right now, they are reluctant to even mention tapering these purchases for fear of further spooking bond markets. Yet the hurdle for exiting QE is surely much lower than that for raising interest rates, which means central banks might not be able to avoid these questions for too much longer, especially in the context of a rapid global recovery and rebound in inflation. In the US, there is also the question about whether banks have the balance-sheet space they need to absorb continued QE, especially as they are running into regulatory constraints and the Treasury has prefunded a large amount of spending that is currently sitting in its account with the Federal Reserve. As the Treasury spends this money, it will add to the stock of reserves in the banking system, which could push overnight lending rates negative. These “plumbing” issues are attracting attention in financial markets, but we think this is something the authorities can easily resolve. The issue of how to escape QE is likely to prove a far greater policy challenge.

Bottom line

The global economic recovery – already well underway in the industrial sector – is set to gain further momentum in the second half of 2021. While this will disproportionately benefit services activity – especially hospitality, travel etc. – manufacturing and world trade should remain buoyant. This will add further fuel to the inflation scare, where commodity and traded goods price are already recovering briskly. Of course, we’ve seen similar episodes in the past, especially immediately after the global financial crisis. But back then markets could take comfort from continued disinflation in services prices. This time, with large distortions in services inflation, underlying price dynamics might start to look scarier. The good news is that central banks will remain calm, retaining their dovish stance because they think it will take time to reverse the economic damage COVID-19 has caused. Officials do not regard the selloff in bonds as a challenge to their credibility, which means they are not compelled to respond – unless there is clearer contagion from bonds to corporate credit and equities. This suggests the reflation trade is not yet over. The bigger credibility challenge for central banks is about how they adjust their asset purchases, eventually exiting QE. They cannot avoid this issue for long.