Inflation, central bank pivots and volatility

As we stand at the beginning of 2023, it will be interesting to see how quickly the financial markets revise their opinion about inflation and a potential shift in central bank monetary policy.

Although we have now moved into a new year, we would argue that not much has changed from an economic point of view, and therefore expect central banks to maintain their current course over the coming quarters. This will lead to very volatile financial markets in 2023.

Headline inflation will remain high

Headline inflation in the EU has probably topped out for now. However, this does not change the fact that inflation is much higher now than it was in the early 1980s.

For this century, inflation is still double its previous peak in 2007 and far above the 2% target level of ECB monetary policy.

Figure 1 EU HICP annual inflation

The HICP (Harmonised Index of Consumer Prices) figure for December 2022 of 10.4% is not going to change the tightening of ECB. A fall in inflation to a level would oblige the central banks to start thinking about actually easing monetary policy is not just around the corner!

Quantrom Limited, 59-60 O'Connell Street,
Limerick, Ireland, V94 E95T

+353 1 513 6215, client@quantrom.com
quantrom.com

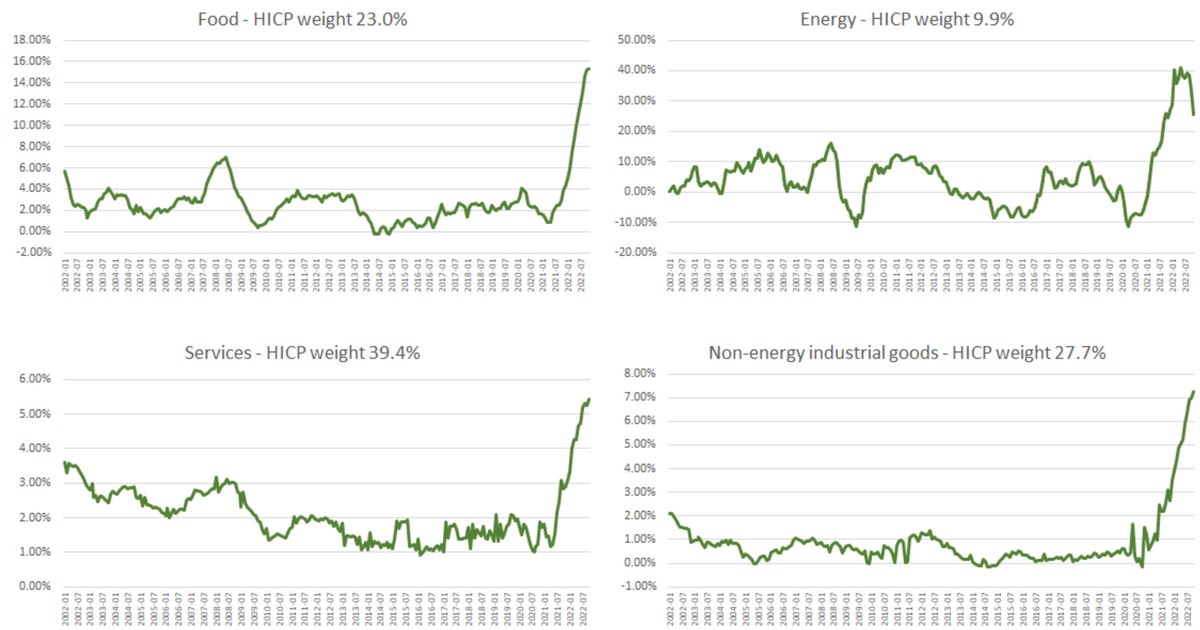
Further, few of the underlying components of headline inflation support such a change in policy near term.

Except energy, main components of HICP continue to rise

The only main driver of the fall in inflation is, of course, energy. After an unusually mild winter so far, and almost full storage, gas prices have fallen to the same level as before the Ukraine war. While this is obviously disinflationary, it should be remembered that energy accounts for less than 10% of the overall price index.

While the energy index indeed has fallen, the remaining 90% of the price index have continued to increase at a level not bringing down inflation (cf. figure 2, below).

Figure 2 Main components of HICP



Services and non-energy industrial goods are more than 67% of the HICP index, and those two components have been acting to lower inflation since 2000. Now, however, this inflationary "anchor" is gone.

Since 2009, services inflation did not exceed 2% until the current upswing in overall inflation. In services, the main cost component is wages and, given a very tight labour market at present, it is difficult to see why employees in the services sector would not demand to be compensated for the higher cost of living. Employees fully understand that high inflation has eroded their real income significantly over the last 12 months. Services inflation is thus more likely to stay at present levels, rather than fall back to below 2%.

The same applies to industrial goods. The notion of cheap imports of goods from China and other Asian countries now seems like a thing of the past, not least because of worldwide geopolitical tensions. Running at seven times the previous inflation level, there is a long way down for this component of the overall price index.

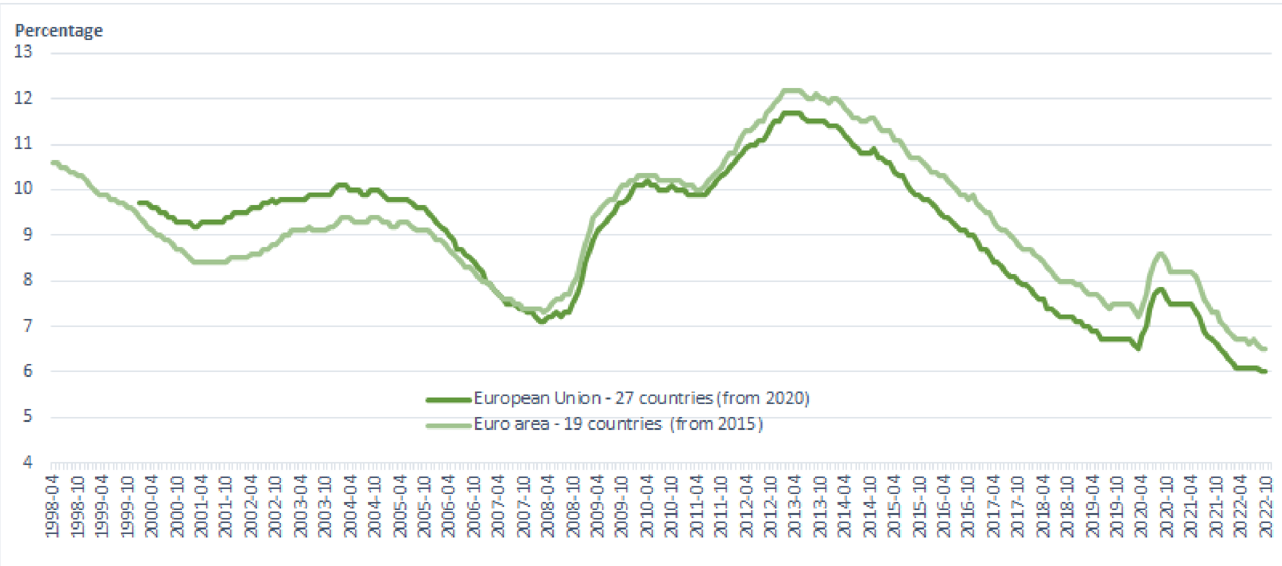
Lastly, food is the one component of the overall price index most likely to decline from its current level of over 14%. But even a halving of food prices inflation will not be able to bring the overall inflation rate down to under 5%.

In our view, the underlying HICP components do not yet indicate that a fast-track path to 2% inflation is in the cards. We remain convinced that inflation will stay around the 7%-8% level in 2023, and thereafter gradually retreat to an inflation level of 4%-7% in the coming years.

A tight EU labour market

The tightness of the labour market is a further indication that bringing down inflation will be difficult (see figure 3, below).

Figure 3 Unemployment level in EU and Euro area



Unemployment in both the EU27 and the eurozone has not been this low in more than 25 years. While the EU27 unemployment rate is down to 6%, the median unemployment rate of individual countries is 5.5%. Only Spain and Greece, where double-digit unemployment rates exist, raise the average.

Employees are in the best position to obtain higher compensation than in the previous 25 years.

One side of the coin is obviously the official negotiations between employers and the unions for wage and salary increases; the other side is many companies seeking to retain personnel by promoting them internally.

On a macroeconomic level, a trend towards internal promotions, such as junior staff becoming senior staff, leads to additional income and demand without increased production, with such employees presumably receiving higher compensation for performing the same work.

ECB - outlook for 2023

Looking ahead, the ECB will have to deal with continuous high inflation and the tightest labour market in decades.

In our view, it is difficult to see a scenario in which the ECB will change its policy stance in 2023. Up for discussion, however, will be the pace of monetary tightening. It is unlikely that the ECB will continue with jumbo hikes of 75bp; 50bp will be a more appropriate pace.

At the same time, the ECB will continue to support countries with the highest interest rates on their government bonds, by continuing to reinvest principals repaid at least in 2023.

This can lead to low growth, and even negative growth, in some quarters, but as long as the labour market remains as robust as it currently is, it is difficult to imagine that the ECB will move toward a more accommodating monetary policy.

To pivot or not to pivot – uncertainty will lead to volatility

Where will this leave the financial markets?

The most likely scenario for the coming 12 months will be one in which there is an ongoing discussion about whether central banks will pivot or not.

Any lower inflation number or negative growth rate will give the market a reason to argue for central banks to lower interest rates, while any high number will have the opposite effect.

This will indeed lead to a very volatile environment for both fixed income and equity markets. For investors, therefore, 2023 looks likely to develop into something of a rollercoaster ride.