Insight INVESTMENT

GLOBAL MACRO RESEARCH

WHY CENTRAL BANKS MAY STRUGGLE TO SOLVE THE INFLATION PUZZLE

MAY 2023

BNY | INVESTMENTS

OVER THE MONTHS AHEAD, HEADLINES ARE LIKELY TO FOCUS ON MODERATING RATES OF INFLATION AND GROWING HOPES THAT CENTRAL BANKS CAN START TO EASE POLICY. ALTHOUGH WE AGREE THAT THERE IS SIGNIFICANT DOWNWARD MOMENTUM TO INFLATION IN THE SHORT TERM, THE MEDIUM-TERM PICTURE IS LESS CLEAR. IF CENTRAL BANKS CUT TOO EARLY, THEY RISK THE MEDIUM-TERM OUTLOOK AND RAISE THE PROBABILITY THAT INFLATION REMAINS STUBBORNLY STICKY ABOVE CENTRAL BANK TARGETS.

EXECUTIVE SUMMARY

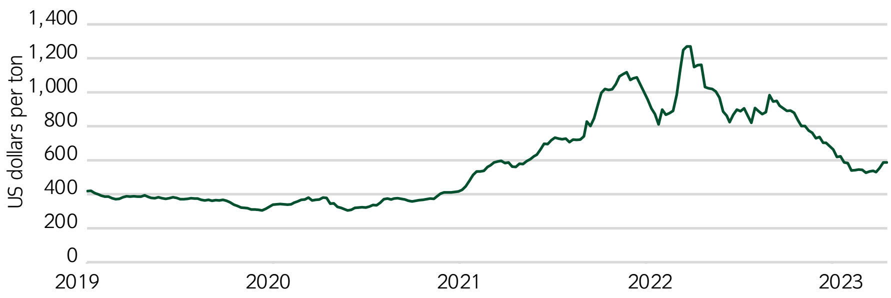
- We highlight six reasons to be positive on the short-term outlook for inflation:
  1. Food prices are moving lower // 3
  2. The energy price spike is over // 3
  3. Shipping costs have returned to pre-pandemic levels // 4
  4. The COVID-related supply chain bottlenecks have dissipated // 4
  5. China's reopening could turbo charge the disinflationary pulse // 5
  6. Manufacturing price pressures are easing // 5
- Service sector inflation is more complicated and tends to be more persistent: // 6
  – There is good news from energy prices
  – But tight labour markets suggest wages will remain a problem
- There is still an open question about inflation persistence: // 8
  – Inflation expectations remain anchored for now
  – But sticky inflation remains a problem
- If growth meaningfully weakens, central banks will be faced with a dilemma, as early cuts may prolong inflationary pressures // 9
- Longer-term inflationary pressures are building, and may make it more difficult to bring inflation back to target on a sustained basis // 10
- Ultimately, if inflation proves to be structurally sticky and economic activity meaningfully weakens, there is a risk that pressure will grow to raise inflation targets // 12

SIX REASONS TO BE POSITIVE ON THE SHORT-TERM OUTLOOK FOR INFLATION

1 FOOD PRICES ARE LOWERING

After moving sharply higher through 2022, global food prices have moderated from their highs. In its March report[1] the Food and Agriculture Organization of the United Nations noted that world food prices had declined by 20.5% from the peak levels seen in March 2022. A normalisation in global fertilizer prices is likely to help maintain the disinflationary pressures in the agricultural sector (see Figure 1).

Figure 1: Fertilizer prices have declined significantly from their highs[2]

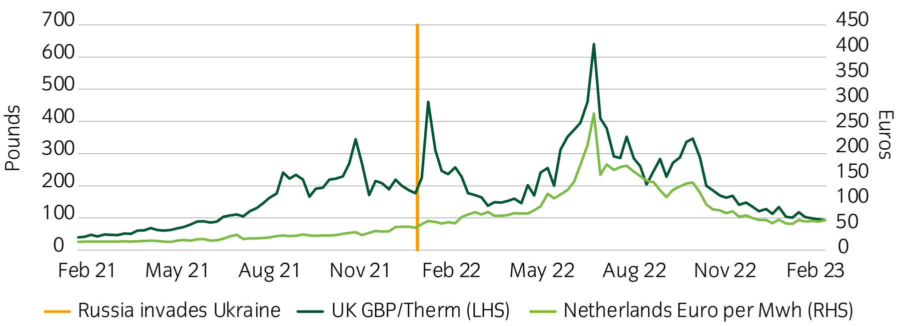


2 THE ENERGY PRICE SPIKE IS OVER

The war in Ukraine continues but the inflationary impact is no longer evident. European gas prices have dropped to below the levels they were trading at before the invasion. As the normalisation of energy prices feeds into inflation statistics, UK and European inflation should be the biggest beneficiary.

Although the risk of future energy spikes is far from over, the huge inflationary impulse from the war in Ukraine has dissipated for now, and energy prices are likely to be a disinflationary force in the months ahead.

Figure 2 European gas prices have reverted to pre-invasion levels[3]



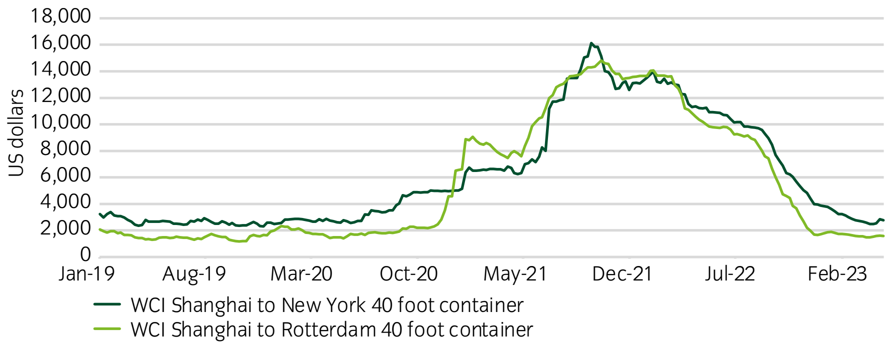
[1] Source: https://www.fao.org/newsroom/detail/benchmark-for-world-food-commodity-prices-fall-in-march-for-the-twelfth-month-in-a-row/en
[2] Source: Insight and Bloomberg. Shows Green Markets North American Fertilizer Price Index. Data as at 14 April 2023.
[3] Source: Insight and Bloomberg. Data as at 14 April 2023.

3 SHIPPING COSTS HAVE RETURNED TO PRE-PANDEMIC LEVELS

One industry that was particularly impacted by the pandemic was shipping A heavy dependence on crew from the developing world, where vaccination rollouts were slow, resulted in staff shortages and a steep rise in global shipping costs. Businesses reliant on bulk orders of goods shipped from Asia and sold at low margins in the West found themselves faced with no choice but to raise prices.

As the impact of the pandemic faded, and newer variants weakened, so the supply of crew increased, and shipping costs started to decline. Shipping rates to Europe have returned to pre-pandemic levels, and shipping rates to the US are now only marginally higher than before the pandemic. This provides considerable relief to global supply chains and goods prices.

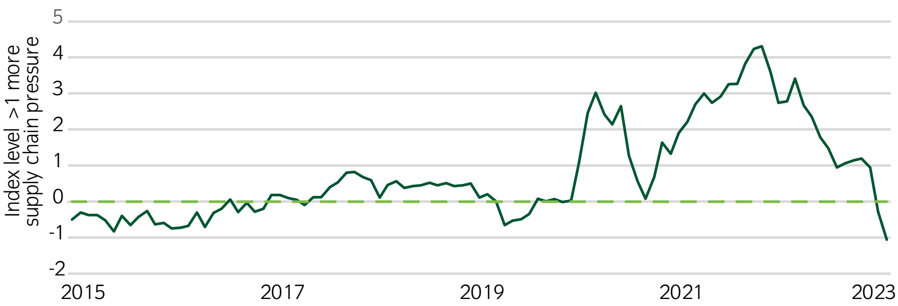
Figure 3: Shipping costs have returned to pre-pandemic levels[4]



4 THE COVID-RELATED SUPPLY CHAIN BOTTLENECKS HAVE DISSIPATED

Normalising global supply chains already explain some of the easing in inflationary pressures into the end of 2022, but this disinflationary force is likely to continue over 2023 as supply chains continue to loosen, putting downward pressure on margins. The New York Fed global supply chain index suggests that global supply chains have now returned to pre-pandemic levels.

Figure 4: New York Fed global supply chain index[5]

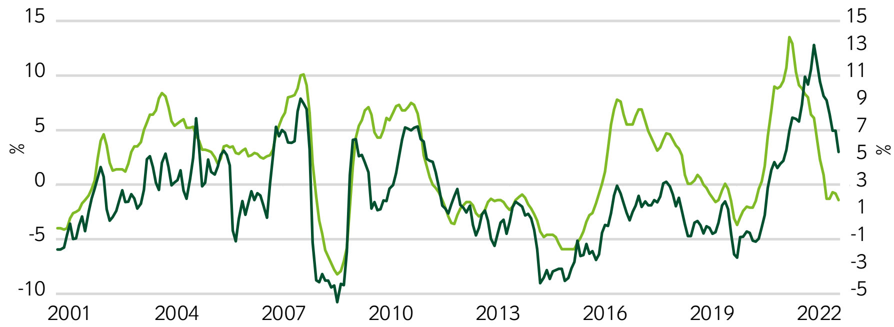


[4] Source: Insight and Bloomberg. Data as at 13 April 2023.
[5] Source: Insight and Bloomberg. Data as at 31 March 2023.

5 CHINA'S REOPENING COULD TURBO CHARGE THE DISINFLATIONARY PULSE

Strict COVID lockdowns in key cities such as Shenzhen, Guangzhou and Dalian saw millions of workers confined to their homes, causing production problems across a range of industries, from high tech to consumer goods. As factories reopen, major corporations will have greater visibility on supply. An improving supply picture from China should turbo charge disinflationary pressures. Compounding this impact, China's producer price inflation (PPI) has moved into negative territory, and has historically had a close correlation with US non-durable goods prices (see Figure 5).

Figure 5: China PPI and US goods inflation[6]

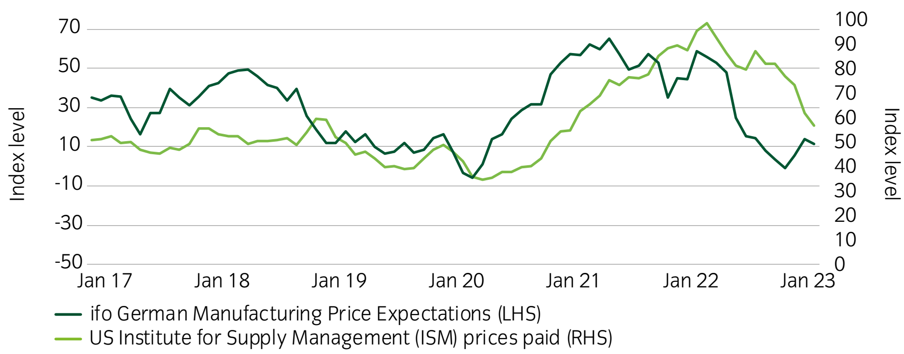


6 MANUFACTURING PRICE PRESSURES ARE EASING

The easing of global supply chain pressures is gradually feeding into the manufacturing sectors of major economies. Survey data shows a clear peak in manufacturing price pressures during 2022.

In the US, survey data from the Institute for Supply Management suggests the majority of manufacturers are now experiencing declining input costs. In Europe, the energy crisis has delayed the impact, but survey data from the Ifo Institute show the number of German companies planning to raise prices is now in decline. A similar trend is apparent across the eurozone and the UK.

Figure 6: Manufacturing price pressures are easing in the US and Europe[7]



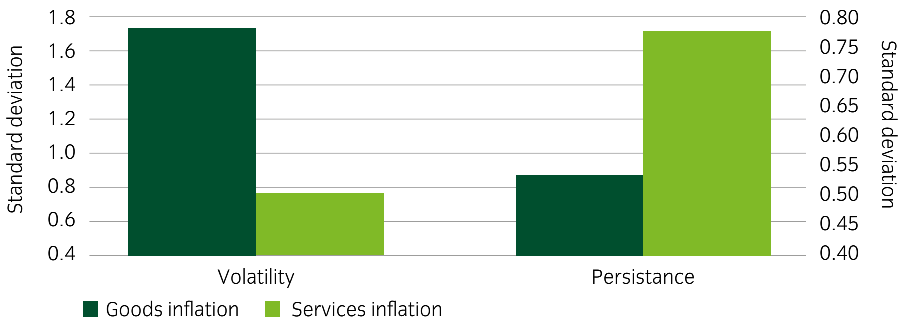
[6] Source: Insight and Bloomberg. Data as at 31 March 2023.
[7] Source: Insight and Bloomberg. Data as at 31 March 2023.

SERVICE SECTOR INFLATION IS MORE COMPLICATED

Traded goods prices, as they are reliant on international factors and input prices, tend to be more volatile than service price inflation, which tends to be based on longer-term trends in wages.

Service sector inflation tends to be more persistent than goods sector inflation, possibly reflecting a less competitive environment given the lower proportion of services that can be traded internationally.

Figure 7: More persistence, less volatility[8]



There is good news from energy prices

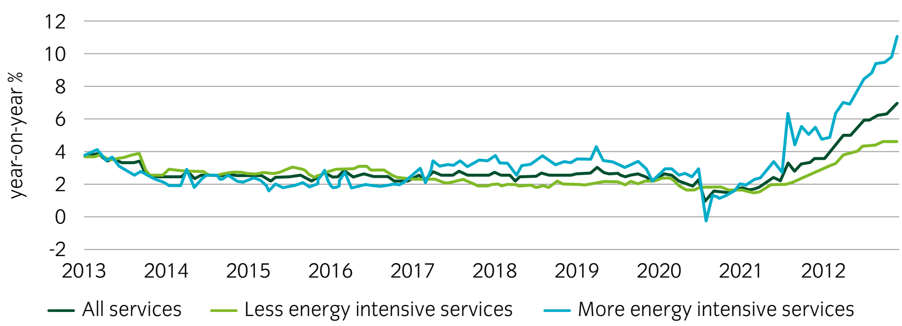
Given the extent of the move in energy prices, the costs of heating, lighting and transportation have all soared. It is likely that an element of service sector inflation will have been impacted by this – but it's very difficult to judge by how much.

Analysis from Oxford Economics – How indirect effects of energy costs are adding to inflation, published in January 2023 – suggests that in the UK, inflation in more energy intensive services has risen considerably faster than in less energy intensive services.

As energy prices have now moderated, it is likely that inflation in these energy-intensive service sectors will start to moderate relatively quickly. In the eurozone, the ECB have done work to break down the impact on service inflation from both energy and the pandemic.

They concluded that sectors that are both contact-intensive and energy intensive (33% of service sector) account for around 2% of service inflation in January 2023.

Figure 8: Inflation has risen faster in energy-intensive services[9]



[8] https://www.bankofengland.co.uk/-/media/boe/files/speech/2021/december/lags-trade-offs-and-the-challenges-facing-monetary-policy-speech-by-ben-broadbent.pdf?la=en&hash=D8CDECB9AFF06D2ACD062C4EEFBC4B20D5343384
[9] Source: Oxford Economics, Haver Analytics.

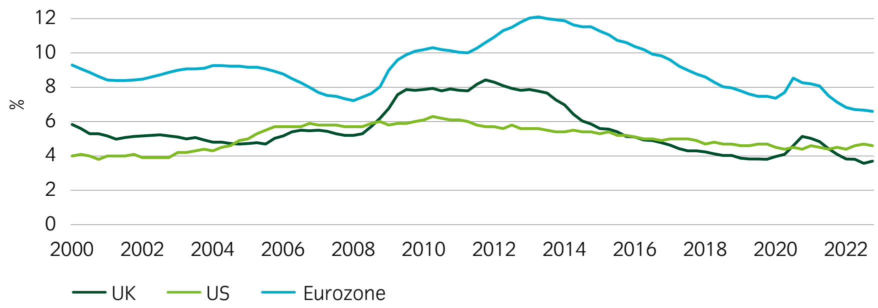
But tight labour markets suggest wages will remain a problem

Despite slowing growth, labour market indicators remain robust and unemployment rates are at historically low levels.

The transmission of tighter monetary policy to the labour market will be crucial in short-circuiting wage expectations, and of course, getting the labour market back to equilibrium. This will be key for monetary policymakers in judging whether the policy stance is appropriate.

Perhaps the most striking thing about the current labour market is the fluid rate at which people are changing job. Rather than becoming unemployed and then employed again with a gap, people are moving from employer to employer and from role to role after much shorter periods of time. This suggests the tightness in labour markets is creating competition for staff and forcing companies to poach from each other – most likely at higher wages.

Figure 9: Unemployment rates are low[10]



The importance of labour costs as a proportion of total costs, especially in the service sector, means that wage inflation is deeply inter-connected with price inflation. The staggered, infrequent (especially in Europe) and decentralised nature of wage setting means that it is likely to take several years for wages to adjust fully to the inflation that has already occurred.

This wage adjustment process could put upward pressure on price inflation over the next two or three years even as long-term inflation expectations remain well anchored and ultimately the long-term behaviour of wages were unaffected by the inflation shock.

The effect of tight labour markets can be seen in wage growth.

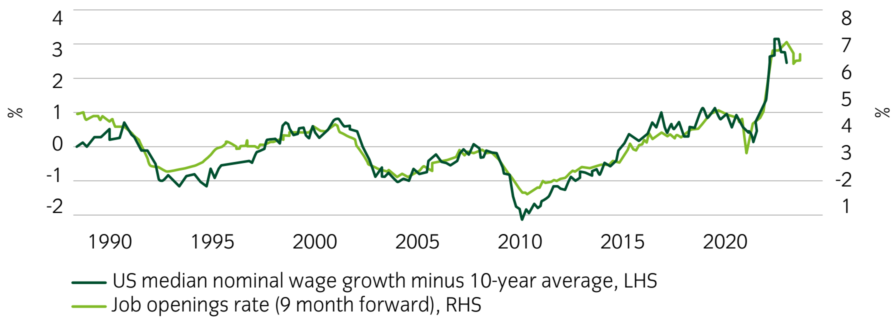
Wage growth is probably past its peak and likely to slow through the year, in part due to falling inflation expectations. This is likely to be more apparent in the US and UK rather than the Eurozone given the previously mentioned tendency of staggered and infrequent wage reviews.

But the tightness in labour markets, as reflected by the unemployment rate and the jobs-workers gap, continues to imply a significant risk of wage growth not falling sufficiently to return core inflation to target sustainably over the medium term. A loosening in the labour market is required to bring wage growth down sustainably. This would comfort central banks that they have done enough, and that inflation will return and remain at target.

A tight labour market and moderating wage growth may not be sufficient for central banks as they would fear they are in an unstable equilibrium. As a consequence, central banks will be focused on the need to keep rates high for some time to allow for a weakening in the economy as they will remain concerned about a re-start of inflation in the future given the strength in the labour market.

[10] Source: Macrobond. Data as at 31 March 2023.

Figure 10: Labour market tightness remains an issue[11]



THERE IS STILL AN OPEN QUESTION ABOUT INFLATION PERSISTENCE

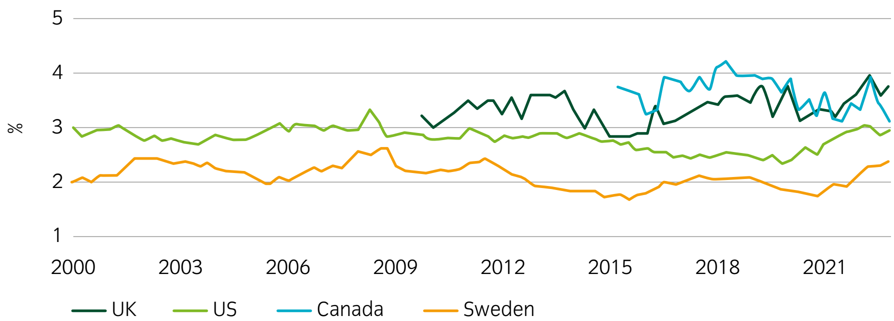
Household expectations are anchored – for now

Central Banks believe that a key task of monetary policy is to make sure inflation expectations align with their inflation target. Although recent surveys show household expectations are elevated, this is not surprising given current levels of spot inflation. This suggests that as inflation moderates, so household expectations should also subside.

Longer-term expectations suggest that household expectations remain anchored for now and central banks will take comfort that the downward sloping term structure of inflation expectations suggests that consumers continue to perceive the current spike in inflation fading over time.

The notable exception is the UK suggesting the risk of inflation persistence is greater with high inflation expectations impacting decision making.

Figure 11: Household inflation expectations[12]



But sticky inflation remains a concern

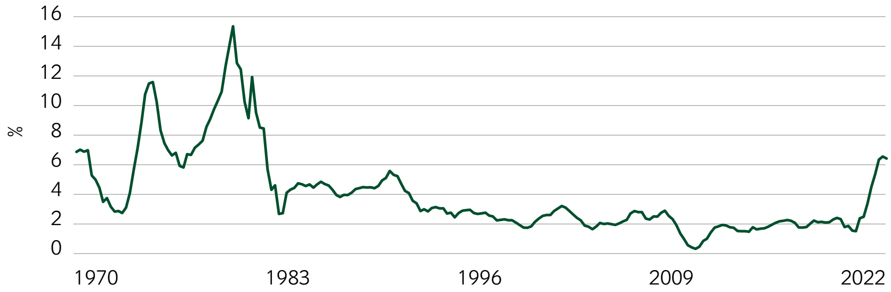
Sticky Price Consumer Price Indices are calculated from a subset of goods and services included in the CPI that change price relatively infrequently. Given their infrequent price change, they are thought by many investors to incorporate expectations about future inflation to a greater degree than prices that change on a more frequent basis.

While a sticky price may not be as responsive to economic conditions as a flexible price, it may do a better job of incorporating inflation expectations. Since price setters understand that it will be costly to change prices, they will want their price decisions to account for inflation over the periods between their infrequent price changes.

This could exacerbate central bank concerns that inflationary trends are not a transitory issue.

[11] Source: BNY Mellon Investment Management, Macrobond. Data as of 21 February 2023.
[12] Source: BofA Global Research.

Figure 12: Atlanta Fed- sticky CPI[13]



CENTRAL BANKS ARE FACED WITH A DILEMMA

Monetary policy operates with a lag…

Studies broadly agree that impact on growth peaks after two to three quarters, and the impact on the level of GDP peaks after approximately five quarters. The ECB estimates that, on average, inflation declines by around 0.3 percentage points and output by 1 percentage point at the peaks of the respective impacts. The range of estimates is large in terms of peak/total impact and lags.

It should be noted that Europe is behind in terms of the transmission of tighter monetary policy, as the tightening started later than in the US and UK. Most of the impact of the tightening of policy by the ECB is expected to materialise during 2023.

MPC member Ben Broadbent estimated a similar impact on growth in the UK. In October 2022 he estimated that if UK rates reached 5.5% (as priced by the market at the time), the cumulative impact on GDP of the entire hiking cycle would be just under 5% – of which only around one quarter has already come through.

Figure 13: ECB: Economic impact of 100bp monetary policy[14]

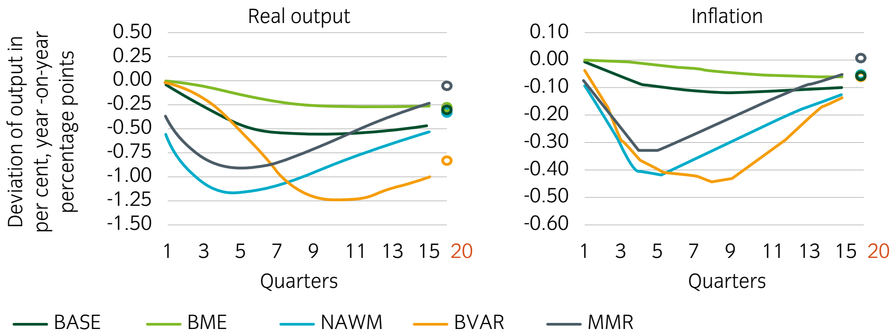
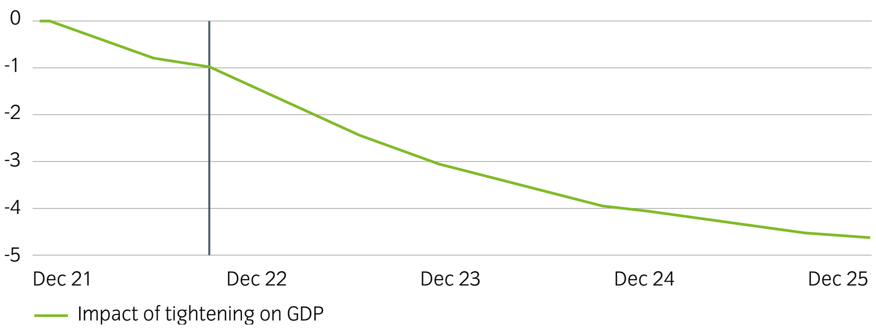


Figure 14: BoE: Cumulative impact on GDP if rates reached 5.5%[15]



[13] Source: Insight and Bloomberg. Data as at 31 March 2023.
[14] Source: ECB. Note: ECB model is the "BASE" model.
[15] Source: Bank of England.

…meaning central banks have a complex pay-off to consider

Globally, with unemployment low and even falling and headline inflation rising, it was relatively easy for central banks to deliver a hawkish message on the need to tackle inflation, despite a worsening forecast outlook for economic growth. As the deacceleration in headline inflation gathers pace in the next few months, it is likely to coincide with a softening in labour markets and a rise in the unemployment rate as the lagged impact of monetary policy starts to come through.

2023 is likely to be a more challenging time for central bank communication. Communicating a need for a tight monetary policy because core inflation was a concern is more of a challenge. Central banks may find themselves under increasing political pressure to stop any further policy tightening and even relax policy as headline inflation moderates from recent extreme levels to one that is closer to target.

Figure 15: Falling inflation, rising unemployment[16]

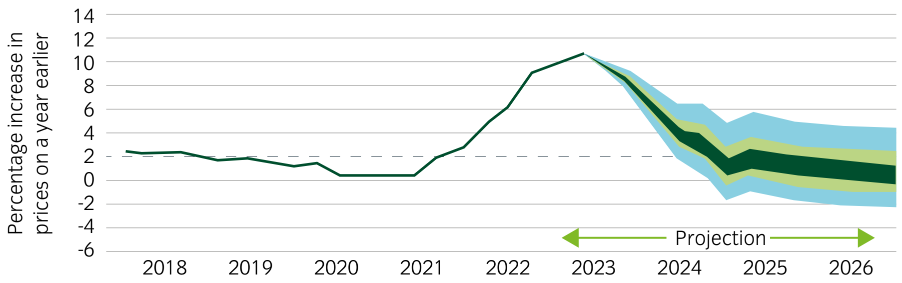
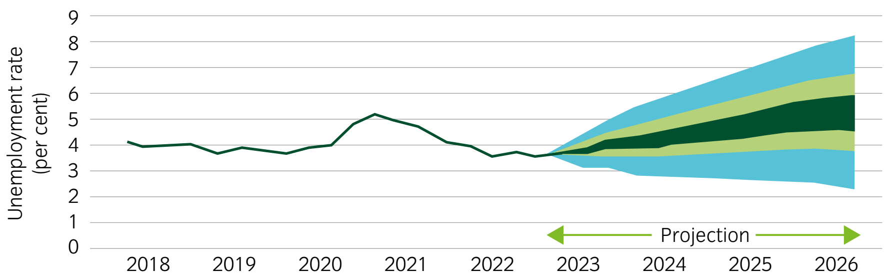


Figure 16: Falling inflation, rising unemployment[17]



LONGER-TERM INFLATIONARY PRESSURES ARE BUILDING

The deglobalisation problem

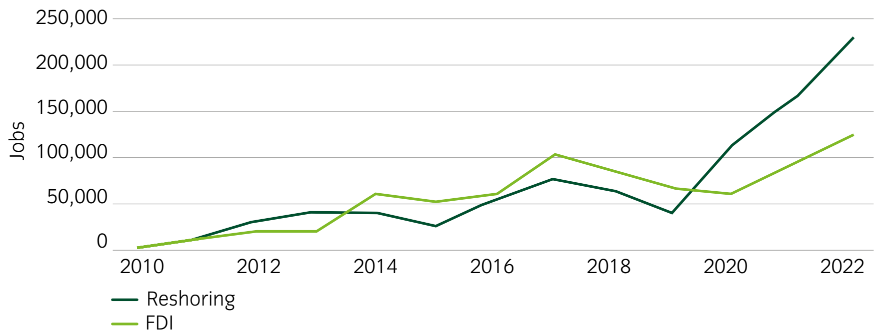
The rapid breakdown of global supply chains that occurred during the pandemic, and the realignment of global politics after the war in Ukraine are likely to see a deeper re-assessment of production models.

At the same time, a focus on decarbonisation and more sophisticated assessments of corporate carbon footprints, are likely to decrease the appeal of long-distance transportation for goods in future. This means that the lower costs and efficiency of globalised, just-in-time supply chains may no longer be a model that works as effectively for many multinationals as it did in the past.

[16, 17] Source: IBank of England Monetary Policy Review.

These factors have led to a sharp increase in the number of US jobs being created from corporates reshoring production from abroad. As a result, we may be at the start of a longer-term trend which sees the disinflationary force of globalisation gradually give way to the more inflationary force of deglobalisation.

Figure 17: US jobs created from reshoring are now in excess of those from FDI[18]

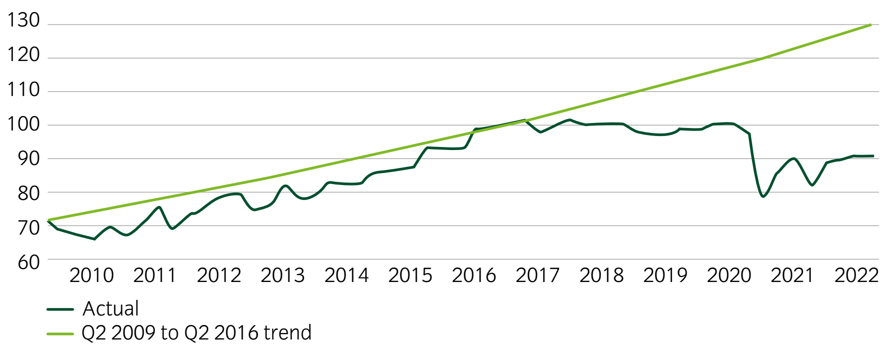


In the UK, Brexit remains an issue

The House of Lords Economic Affairs Committee in its report "Where have all the workers gone?[19]", published in December 2022 noted that:

> "Changes to the structure of migration have had an impact on vacancies, which recently hit record high levels. In recent years many EU workers, who filled lower paid roles (especially in sectors like agriculture and hospitality), have left the UK. In numerical terms, their departure has been counterbalanced by the arrival of non-EU workers, who were granted visas under the new immigration system which prioritises skilled workers. This has contributed to a mismatch within the labour force, accentuating vacancies and labour shortages in certain sectors."

Figure 18: UK business investment relative to trend[20]



[18] Source: Macrobond. Data as at 31 January 2023.
[19] https://committees.parliament.uk/committee/175/economic-affairs-committee/news/175197/early-retirement-and-our-ageing-population-are-causing-labour-shortages-says-lords-report/
[20] Source: Financial Times.

CONCLUSION

Inflation has peaked globally and is widely expected to decline over the course of 2023. Although welcome news for the world's central banks there is still significant uncertainty ahead. In our view, there is a significant difference between the short-term and medium-term outlooks, and there is significant uncertainty as to how central banks will react to each. Ultimately this will come down to four key questions, the answers to which will become clearer in the months ahead:

1. **How low can inflation go in the short-term?** At the start of this paper, we outlined six reasons to be positive on the short-term outlook for inflation. Some of these factors have significant momentum and there is a scenario in some countries where headline measures of inflation could turn negative.
2. **Will central banks move too quickly?** Major central banks are approaching the end of their tightening cycles to various degrees. Faced with inflation potentially rapidly converging with target in some cases, pressures are likely to build to ease rates. This is likely to be exacerbated if economic data proves softer than expected.
3. **Where will inflation normalise to in the medium term?** As the disinflationary factors we have outlined fade, inflation will normalise and establish a new pattern. We believe it is unlikely that inflation will revert to the low levels experienced in recent decades. With globalisation turning to deglobalisation, the longer-term outlook for inflation has deteriorated, and there are various other factors that could compound this. In part, the medium-term outlook will also depend on how central banks react over the next 12-18 months. Cutting to early will likely result in inflation normalising at a higher rate than if central banks maintain their focus.
4. **How will central banks react if political pressures grow?** If inflation proves to be structurally sticky above central bank targets in the medium term, then central banks will have to maintain rates at restrictive levels, and this will have consequences for growth. A period of sub trend growth may be the acceptable pay-off to keep inflationary pressures in check, but this becomes more complex if growth weakens more meaningfully. There is a risk that political pressures grow and that inflation targets are potentially increased to accept higher levels of inflation.

CONTRIBUTORS

David Hooker,
Senior Portfolio Manager
Fixed Income Group
Insight Investment

Simon Down
Senior Investment Content Specialist
Insight Investment

FIND OUT MORE

Institutional Business Development
businessdevelopment@insightinvestment.com

European Business Development
europe@insightinvestment.com

Consultant Relationship Management
consultantrelations@insightinvestment.com

North America Business Development
inquiries@insightinvestment.com

Australia Business Development
insightau@insightinvestment.com

company/insight-investment

www.insightinvestment.com

IMPORTANT INFORMATION

Material in this publication is provided for general information and educational purposes only and should not be relied upon as a forecast, research, advice (including investment, legal, tax advice or otherwise) or a recommendation to buy or sell any securities or adopt any investment strategy. Nothing herein constitutes an offer or solicitation in any jurisdiction where such activity would be unlawful or otherwise not permitted.

This content may include forward-looking statements, projections, or opinions based on current market conditions. Such statements are not guarantees and are subject to change without notice. Past performance is not indicative of future results, and investment values may fluctuate, including as a result of exchange rate movements.

Information is derived from sources believed to be reliable but is not guaranteed as to its accuracy or completeness. To the extent this document includes information or content provided by third parties, no responsibility is accepted for the accuracy of such information. To the maximum extent permitted by applicable law, Insight and its affiliates expressly disclaim all liability for any errors, inaccuracies, or omissions in this document. Neither Insight or its group companies shall be liable for any loss or damage (whether direct, indirect, special, or consequential) arising from the use of, or reliance on, the information in this document to the fullest extent permitted by law. Readers should seek independent professional advice before making any financial or investment decisions.

Telephone conversations may be recorded in accordance with applicable laws.

For clients and prospects of Insight Investment Management (Global) Limited: Issued by Insight Investment Management (Global) Limited. Registered in England and Wales. Registered office: 160 Queen Victoria Street, London EC4V 4LA; registered number 00827982.

For clients and prospects of Insight Investment Management (Europe) Limited: Issued by Insight Investment Management (Europe) Limited. Registered office: The Shipping Office, 20-26 Sir John Rogerson's Quay, Dublin 2, D02 Y049. Registered in Ireland. Registered number 581405. Insight Investment Management (Europe) Limited is regulated by the Central Bank of Ireland. CBI reference number C154503.

For clients and prospects of Insight Investment International Limited: Issued by Insight Investment International Limited. Registered in England and Wales. Registered office 160 Queen Victoria Street, London EC4V 4LA; registered number 03169281.

Insight Investment Management (Global) Limited and Insight Investment International Limited are authorised and regulated by the Financial Conduct Authority in the UK.

For clients and prospects based in Singapore: This material is for Institutional Investors only. This documentation has not been registered as a prospectus with the Monetary Authority of Singapore. Accordingly, it and any other document or material in connection with the offer or sale, or invitation for subscription or purchase, of Shares may not be circulated or distributed, nor may Shares be offered or sold, or be made the subject of an invitation for subscription or purchase, whether directly or indirectly, to persons in Singapore other than (i) to an institutional investor pursuant to Section 304 of the Securities and Futures Act, Chapter 289 of Singapore (the 'SFA') or (ii) otherwise pursuant to, and in accordance with the conditions of, any other applicable provision of the SFA.

For clients and prospects based in Australia and New Zealand: This material is for wholesale investors only (as defined under the Corporations Act in Australia or under the Financial Markets Conduct Act in New Zealand) and is not intended for distribution to, nor should it be relied upon by, retail investors.

Insight Investment Management (Global) Limited is exempt from the requirement to hold an Australian financial services licence under the Corporations Act 2001 in respect of the financial services; and is authorised and regulated by the Financial Conduct Authority (FCA) under UK laws, which differ from Australian laws. If this document is used or distributed in Australia, it is issued by Insight Investment Australia Pty Ltd (ABN 69 076 812 381, AFS License No. 230541) located at Level 2, 1-7 Bligh Street, Sydney, NSW 2000.

For clients and prospects of Insight North America LLC: Insight North America LLC is a registered investment adviser under the Investment Advisers Act of 1940 and regulated by the US Securities and Exchange Commission (SEC). Registration with the SEC does not imply a certain level of skill or training. The SEC has not reviewed or approved any calculation or presentation of performance results included in these materials. INA is part of 'Insight' or 'Insight Investment', the corporate brand for certain asset management companies operated by Insight Investment Management Limited including, among others, Insight Investment Management (Global) Limited, Insight Investment International Limited and Insight Investment Management (Europe) Limited (IIMEL).

15837-05--23