ECB BMCG,
Bond Market Developments
Group Economic and Macro Strategy,
May 27, 2021
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US Inflation: FAIT Perspective

FAIT\(^1\) is presented at the Jackson Hole Symposium on August the 27\(^{th}\) 2020

- No market reaction for over 2M: FAIT does not induce higher inflation expectations. It tells the market the CB reacts to above target inflation readings after a while. In so doing the CB makes room for higher inflation expectations
- Market reacts to expansionary fiscal policy prospects after the Democrats secure the presidency (1\(^{st}\) leg: Nov – Dec) and Congress (2\(^{nd}\) leg: since Mid-Jan)

Despite 5Y BE inflation rose to historically high level, market is not pricing inflation spiraling out of control (unusually, 5Y,5Y forward BE inflation < 5Y BE inflation)

- Positive base effect, rising commodity prices, bottlenecks due to value chains repatriation, government sponsored consumer demand lower price sensitivity are already priced in
- The time to decide if these adjustments are sticky and generate 2\(^{nd}\) round effects is still a few months away

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\(^1\) FAIT = Flexible Average Inflation Targeting
US Inflation: Relative Prices Adjustments vs Genuine Inflation

- Inflation is on the rise due to base effect and commodities’ prices rise
- Core inflation confirms the peculiarity of the moment
- Trimmed inflation shows extreme changes are major contributors to core and headline rise
- The combination of these indexes and the large labor market miss in April squares with Fed’s inflation “hump”
- Inflation worries call for tapering being hinted at by the Fed before 4q21\(^{(1)}\)

Participation Rate (yellow, 6M Mav is bold); Prime Age Participation Rate (white, 6M Mav is bold)

Topics for Discussion

- FAIT regime implies the Fed acts on inflation and labor market improvements being measured. **Will the labor market be tight enough by 4q21 to justify tapering talks?**
- Does market weigh inflation too much and labor market too little?
- US is about 8mn workers short of pre-C19 level. **Is the US economy flexible enough to entice discouraged workers back in the market by year end?**

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\(^{(1)}\) BoFA Global Research Fx and Rates Sentiment Survey shows market participants see hints of tapering more likely than not by the September Fed meeting and at 93% by the year end (39% sees tapering being hinted at in 4q21)
**Euro Zone Inflation: Need for More**

- Better economic prospects and tapering talks in US triumph stronger ECB’s market print since the March GC Meeting
- EUR rise in sync with higher (currency-hedged) EZ yields
- Inflation expectations still low after a significant run upward.
  - Market is currently pricing almost constant inflation at 1.6% y/y over the next 10Y
  - HICP is at 1.6% y/y. Market is not pricing much out of monetary and fiscal policies boost

**Topics for Discussion**

- PEPP ends in March 2022 as anti-C19 vaccination rolls on and market expects EZ growth to take off later in 2021. A stronger EUR feeds on these elements. **What would the ECB do to counter financial condition tightening? Larger APP, possibly?**
- Priced inflation is way off record highs despite strong economic growth. **Could FAIT be introduced in EZ too? Will core country accept that?**
- How introducing housing services in the HICP basket makes ECB monetary policy more effective?

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*(1) ECB’s capital key weighted 10Y yield of Germany, France, Italy, Spain, The Netherlands. Vertical line is Mrs. Lagarde announcing “significantly faster” purchases
(2) 5Y BE is 5Y Zero Coupon Inflation Swap; BE 5Y,5Y forward is based on 10Y and 5Y Zero Coupon Inflation Swap*
TOPICS FOR DISCUSSION: RECAP

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