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## US INFLATION: FAIT PERSPECTIVE

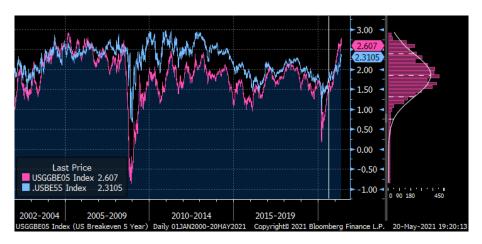
10Y Nom. (white); 10Y Real (blue); BE 10Y (green); BE 5Y (mauve)



# FAIT<sup>1</sup> is presented at the Jackson Hole Symposium on August the 27<sup>th</sup> 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 <u>after</u> the Democrats secure the presidency (1<sup>st</sup> leg: Nov – Dec) and Congress (2<sup>nd</sup> leg: since Mid-Jan)

#### BE 5Y (mauve); BE 5Y,5Y forward (blue)



- 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)</li>
- 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<sup>nd</sup> round effects is still a few months away



## US Inflation: Relative Prices Adjustments Vs Genuine Inflation

#### CPI (orange); Core CPI (blue); Trimmed CPI (yellow)



- 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 4g21<sup>(1)</sup>

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?



## **EURO ZONE INFLATION: NEED FOR MORE**

10Y US (yellow); 10Y Big5 USD-hedged<sup>(1)</sup> (white); EUR (green); EUR Trade Weighted (orange)



- Better economic prospects and tapering talks in US triumph stronger ECB's market print since the March GC Meeting
- EUR rise in synch 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

BE  $5Y^{(2)}$  (mauve); BE 5Y,5Y forward (blue); HICP y/y



### **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?



## TOPICS FOR DISCUSSION: RECAP

- 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?
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- 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?
- 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?
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# **CONTACTS**

Fabio Noacco

Group Economic and Macro Strategy

Mediobanca – Banca di Credito Finanziario

fabio.noacco@mediobanca.com

