Macro Outlook Summary

26 January 2022

It's hard not to keep raking over the inflation data and outlook which remains worrying. Echoing our repeated point, in January the BoE did comment that rate hikes don't solve supply chain problems or help lower the gas price and increase supply. Over these issues they have no control and are signalling their concern. Nevertheless, with the December CPI inflation print at 5.4% and looking likely to stay there for most of this year they have to target removing the cheap and easy money which has become inappropriate and has been driving asset prices higher. UK 5yr fixed rate mortgages are currently offered at 1.5% which looks like a misprint given the inflation data. In Switzerland the same mortgage costs fractionally less at 0.6% and inflation is running at 0.6%. Central banks are certainly facing a conundrum. Monetary policy has been proven to work well in managing the supply and price of credit to consumers and therefore aggregate demand. But not since the 1970s has the global economy faced supply and input shortages. Since then, the cause of economic overheating has been excess demand, which has been well managed by monetary policy.

Today the shortages of commodities, raw materials, intermediate products like chips are all so reminiscent of the 70's, along with high energy prices again due to supply disruptions. Killing off demand to relieve these supply bottlenecks is clearly a bad solution and will lead to recession. That is not a central bank mandate. But letting inflation data continue to run risks a feedback loop into wage rises becoming entrenched in the system and the popular psyche. Inflationary expectations would no longer be anchored and low. Staged and moderate wage rises should not be an issue but if evolved into frequent repetitive claims and wage spirals then true inflation has returned. The rate of change and momentum behind these dynamics is what matters. The question then is to what level rates must rise to dampen input cost pressures and the workforce, without tipping the economy into recession. With a highly indebted economy, sensitivity to higher interest rates is greatly enhanced and therefore terminal rates cannot get to where they peaked in previous cycles.

But in addition, the sensitivity of borrowers to rate hikes is not linear. Early hikes have little or no effect. Later hikes have increasing impact and one will mark the inflection point at which hikes should stop before triggering a recession. No one knows where to mark that level but inflation data will be a poor indicator of when this point has been reached and yet it is the primary gauge on which central bank credibility is scored.