Macro Outlook Summary

31 December 2021

One month after the emergence of the Omicron variant, markets have recovered to all-time highs, apparently concluding that the reopening trade has not yet been de-railed. This optimism is understandable given the evidence that this variant is not as deadly as initially feared. But the unchecked acceleration in cases, burden on care systems and inevitable restrictions have yet to be discounted properly by markets. Even in countries with the highest levels of vaccination the growth in cases over four weeks has been remarkable. The next four weeks seem likely to produce a level of incidence which may be hard to believe.

Whatever may pass, however, the bigger and related story is the resurgence of inflation and central bank responses. Text books say that there are two types of inflation driver – cost push and demand pull. The 60's and 70's were littered with cost push inflation spikes which all proved difficult for central bank policy to control. Monetary policy is a very blunt tool to fight the cost push inflationary effects of an energy crisis. Monetary policy has proven to be a good tool to manage demand pull inflation but provides no solution to a supply side shortage.

The globalisation movement in the 80's meant supply bottlenecks quickly became a thing of the past, which relegated cost push inflationary spikes to the history books. The broad components of cost push inflation can be broken down into two simple categories - those which are transient and those which are sticky. Commodity prices, energy prices, transport costs can all go down as well as up and the last 40 years bear witness to some extraordinary moves up and down. We regard these as transient even if their cycle may be long in duration. Rising wages caused by labour shortages however are a completely different issue in that wages go sideways or up, but never down. Coupled with long overdue increases in minimum wages which began three years ago and the last two years giving so many in the workforce the opportunity to re-evaluate their work-life priorities, these strands are winding together to create a disrupted and tight labour market across multiple industries in many countries. Higher wages are sticky input cost inflation and are certain to be passed on as much as possible in the pricing of goods or services being sold. But when those goods and services are also themselves in short supply, we believe the efficacy of monetary policy is low.

What this means is that for the first few hikes in rates in the US and UK there is unlikely to be any discernible improvement in these shortages. They're just not connected. Demand will be marginally dampened but as we know from every previous rate hiking cycle the first few hikes will simply pick up the slack in monetary policy and it is the mid stage and late-stage hikes which really impact consumer demand and behaviour. The upshot is that terminal rates will be higher than currently priced in the government bond market and the inflationary cycle will last longer than currently thought.