



ECB BMCG, BOND MARKET DEVELOPMENTS

Group Economic and Macro Strategy,
May 27, 2021



MEDIOBANCA

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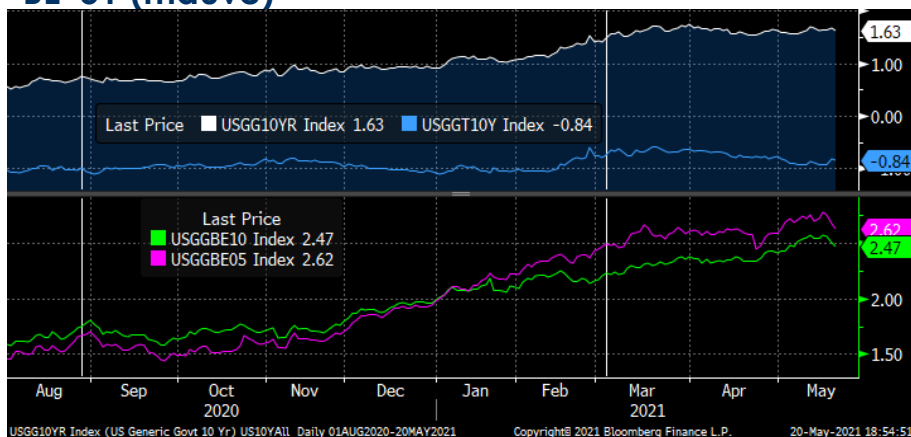
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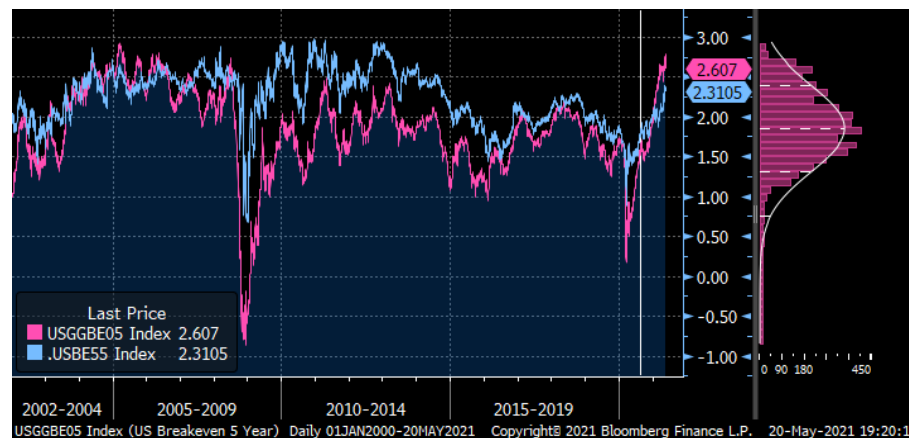
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US INFLATION: FAIT PERSPECTIVE

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



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

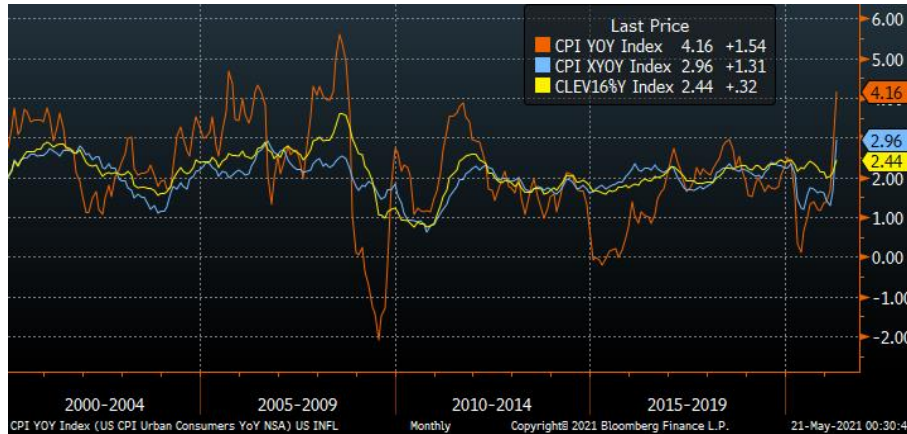


- ◆ FAIT¹ is presented at the Jackson Hole Symposium on August the 27th 2020
- ◆ No market reaction for over 2M: FAIT does not induce higher inflation expectations. It tells the market the CB reacts to above target inflation readings after a while. In so doing the CB makes room for higher inflation expectations
- ◆ Market reacts to expansionary fiscal policy prospects after the Democrats secure the presidency (1st leg: Nov – Dec) and Congress (2nd leg: since Mid-Jan)

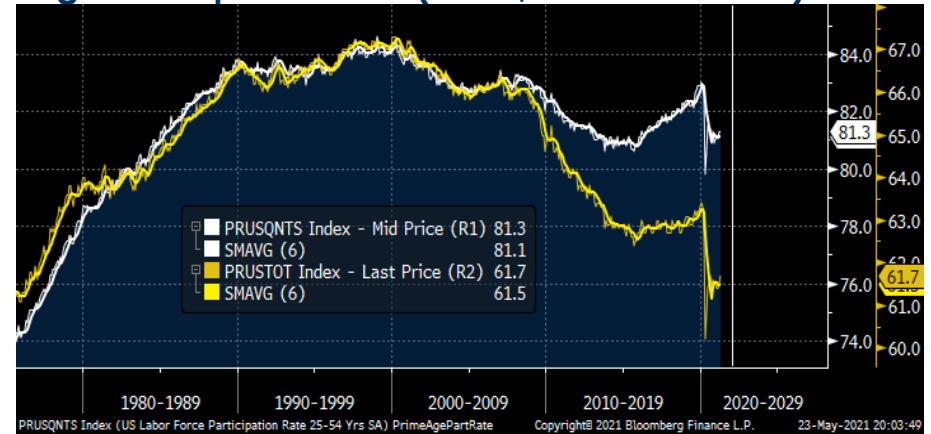
- ◆ Despite 5Y BE inflation rose to historically high level, market is not pricing inflation spiraling out of control (unusually, 5Y,5Y forward BE inflation < 5Y BE inflation)
- ◆ Positive base effect, rising commodity prices, bottlenecks due to value chains repatriation, government sponsored consumer demand lower price sensitivity are already priced in
- ◆ The time to decide if these adjustments are sticky and generate 2nd round effects is still a few months away

US INFLATION: RELATIVE PRICES ADJUSTMENTS VS GENUINE INFLATION

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



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



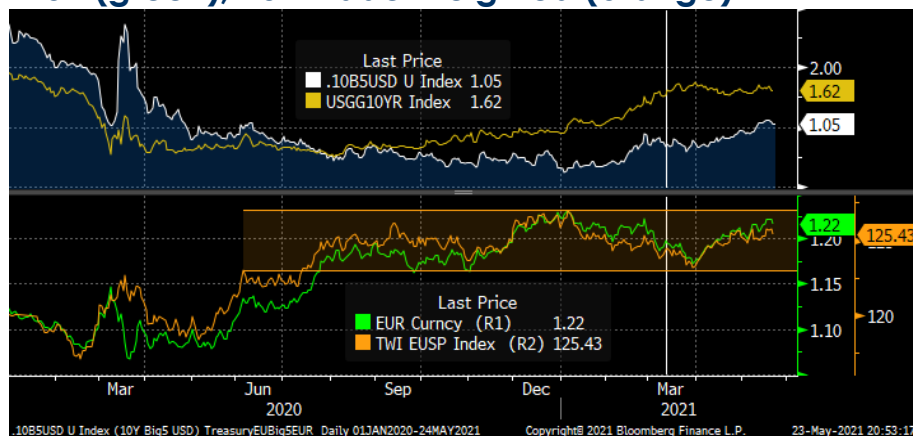
- ◆ Inflation is on the rise due to base effect and commodities' prices rise
- ◆ Core inflation confirms the peculiarity of the moment
- ◆ Trimmed inflation shows extreme changes are major contributors to core and headline rise
- ◆ The combination of these indexes and the large labor market miss in April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

Topics for Discussion

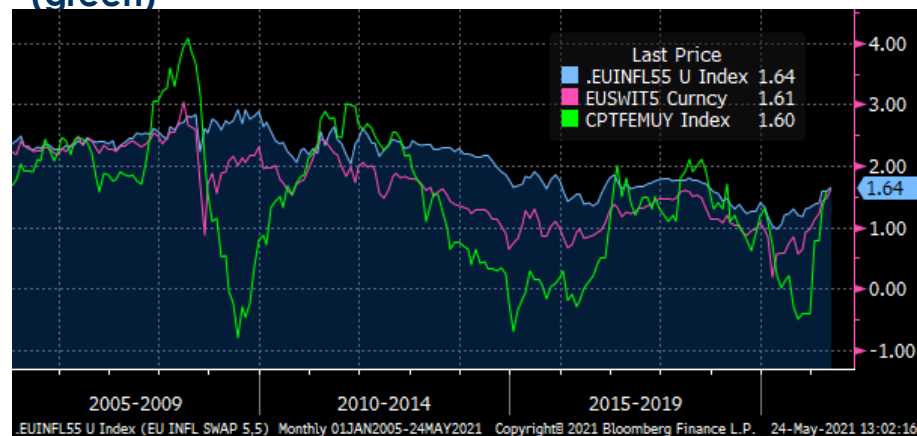
- ◆ FAIT regime implies the Fed acts on inflation and labor market improvements being measured. **Will the labor market be tight enough by 4q21 to justify tapering talks?**
- ◆ Does market weigh **inflation too much and labor market too little?**
- ◆ US is about 8mn workers short of pre-C19 level. **Is 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⁽¹⁾ (white);
EUR (green); EUR Trade Weighted (orange)



BE 5Y⁽²⁾ (mauve); BE 5Y,5Y forward (blue); HICP y/y (green)



- ◆ 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

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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