



ALLIANZ RESEARCH

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# DEMYSTIFYING THE FOUR HORSEMEN OF THE INFLATION APOCALYPSE

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- 04 Reflation is not inflation
- 08 Inflation outlook for the US and the Eurozone



# EXECUTIVE SUMMARY

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- **Will Covid-19 be the inflation game-changer? We are firmly in the “reflation” not “inflation” camp: expect a temporary inflation overshoot in the coming months, rather than consumer prices galloping out of control.** While initially the economic setback in H1 2020 stoked deflationary fears, with inflation rates across most OECD countries declining to zero, the debate quickly shifted to the risk of the Covid-19 crisis ringing in the end of the low inflation era, as we first noted in fall 2020<sup>1</sup>. We do expect inflation rates to re-accelerate notably in 2021, thanks to (i) the recent input cost bonanza, driven above all by strained supply chains and recovering commodity prices; (ii) higher services inflation along with the economic reopening in H2 and (iii) strong pandemic-related roller coaster base effects. But these are transitory drivers and their impact should fade as the economic recovery advances. Inflation will hence only stage a temporary overshoot in the US and briefly hit the ECB’s “below, but close to, 2%” target in the Eurozone in 2021.
- **But what about the wild cards that the Covid-19 crisis has dealt? We demystify the four horsemen of the inflation apocalypse:**
  1. **Markets are sounding the inflation alarm!** Market-based measures of inflation need to be interpreted with caution. Actually we think markets are overreacting to the reflation story on the back of taper phantasies rather than developments in the real economy. Our proprietary model for 10y US breakeven inflation rates based on a direct relationship between realized monthly inflation rates (smoothed) and market-based inflation expectations currently shows a remarkable overshoot. Trading at 2.3%, 10y US breakeven inflation lies more than one standard deviation above the fair value estimated at 1.5-1.6%, severely limiting the further upside potential.
  2. **The recent input price bonanza is a harbinger of galloping consumer price inflation!** Far from representing a new super-cycle, we think it represents temporary challenges around the economic restart. While we do expect input prices to consolidate at current elevated levels in the second half of this year, largely unclogged supply chains and normalizing demand will see input prices settle at a lower price on average in 2022, compared to the start of 2021, so that positive base effects should reverse and keep a lid on price pressures.
  3. **A looming wage-price-spiral is certain to transport us straight back to the 1970s!** The sharp rebound will provide some much needed tailwind to labor markets, but cleaning up the Covid-19 economic legacy will take some time. Subdued labor market prospects in the Eurozone should keep a firm lid on wage growth (below 3%) in the medium-term. Meanwhile even for the US economy – where we have seen strong jobs reports and which is likely to run notably hotter over the next few years – we expect wage growth to remain below 4%.
  4. **The unprecedented policy response is bound to bring structurally higher inflation!** We think it’s a free lunch—for now. Money supply growth is a poor guide for realized inflation; the often neglected indicator to focus on is money velocity, which declined in 2020 as part of a long-term trend. Both this long-term trend and its recent acceleration reflect an increase in the demand for money for precautionary purposes. In the unprecedented scenario where money velocity would instantly revert to its long-term trend, it would immediately add 8pp to the growth of global nominal GDP. In front of this very implausible assumption, there is the reality of still large output gaps that could absorb a good deal of such a demand shock before pushing inflation significantly up.

<sup>1</sup> Please refer to our report [“Inflation: Back to the 1970s?”](#)

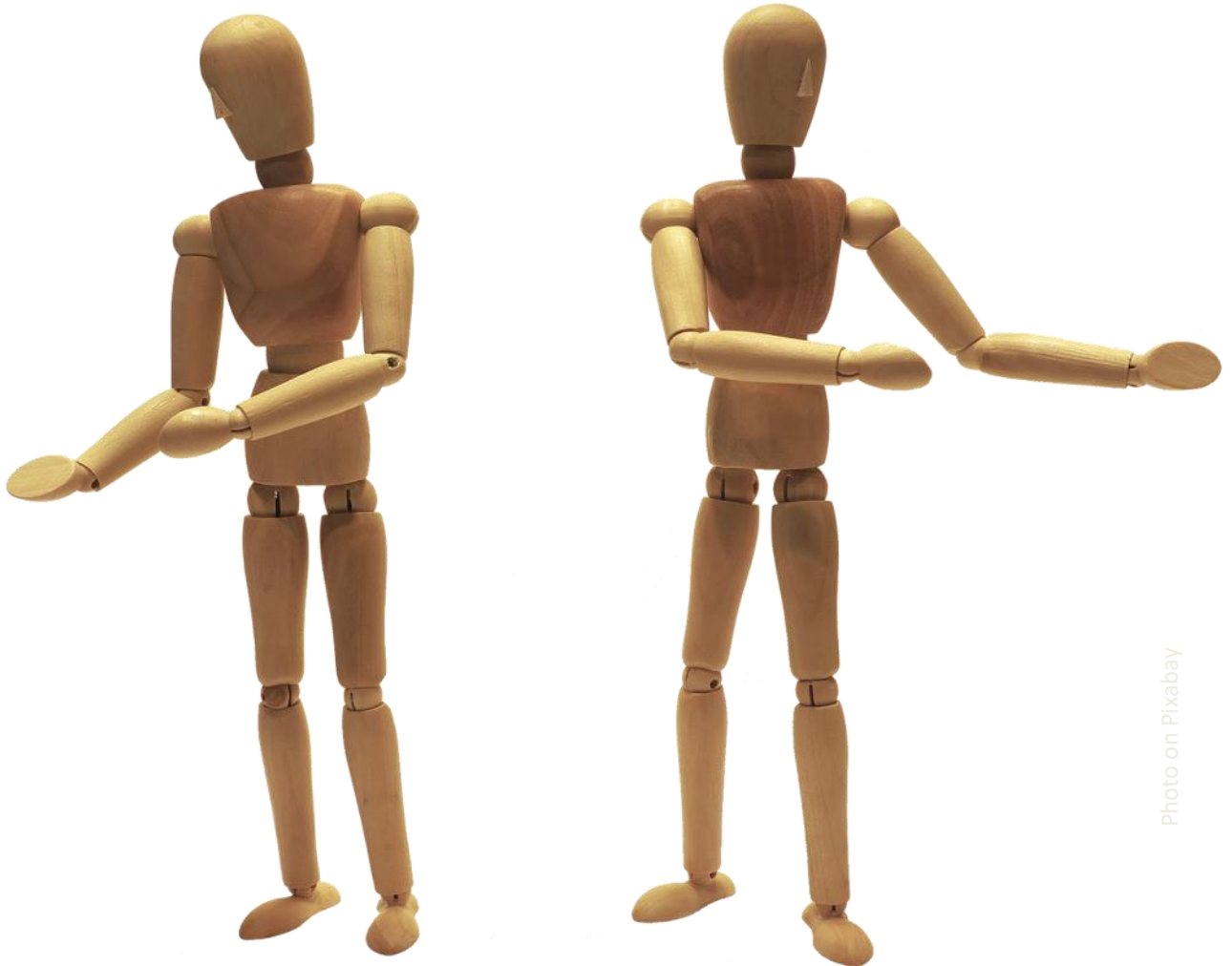


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**Prepare for a temporary overshoot of inflation in 2021.**

# REFLATION IS NOT INFLATION

Ahead of the Covid-19-shock, inflation across developed economies — particularly in the Eurozone — seemed to be largely stuck in a low rut. While initially the economic setback in H1 2020 stoked deflationary fears, with inflation rates across most OECD countries declining to zero, the debate quickly shifted to the risk of the Covid-19 crisis ringing in the end of the low inflation era, as we first noted in fall 2020<sup>2</sup>.

In the Great Inflation Debate, we are firmly in the “reflation” and not the “inflation” camp. Far from seeing consumer prices galloping out of control in 2021, we expect to see a temporary inflation overshoot in the coming mon-

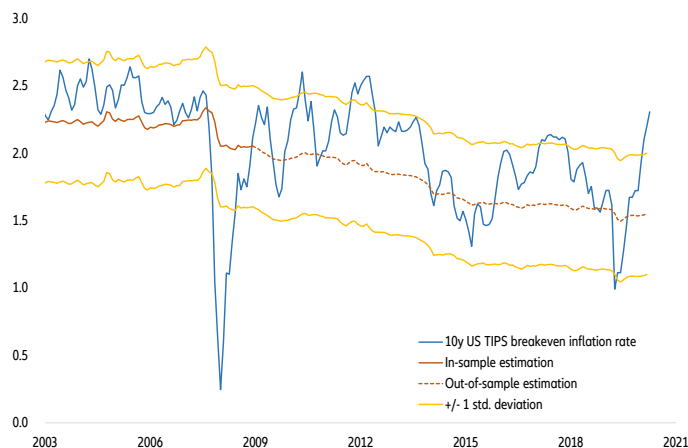
ths, thanks to (i) the recent input cost bonanza, driven above all by strained supply chains<sup>3</sup> and recovering commodity prices; (ii) higher services inflation along with the economic reopening in H2 and (iii) strong pandemic-related roller coaster base effects. But these are transitory drivers and we expect their impact to fade as the economic recovery advances. Inflation will hence only stage a temporary overshoot in the US and briefly hit the ECB’s “below, but close to, 2%” target in the Eurozone in 2021 (see part 2 for more details).

But what about the wild cards that the Covid-19 crisis has dealt? Let’s demystify the four horsemen of the inflation apocalypse:

## 1. Markets are sounding the inflation alarm!

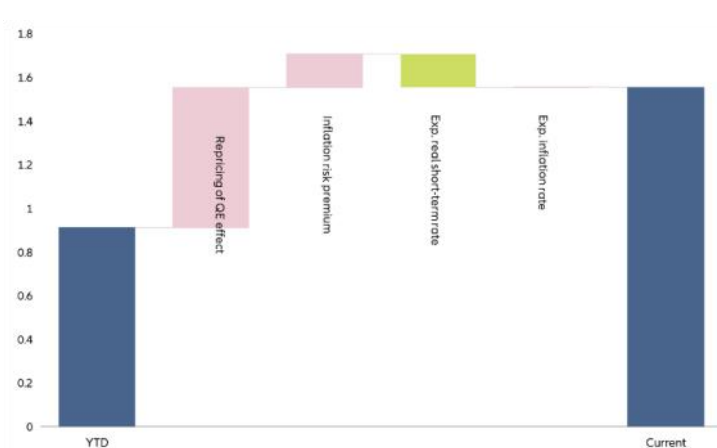
**Actually we think markets are overreacting to the reflation story....:** Our proprietary model for 10y US breakeven inflation rates based on a direct relationship between realized monthly inflation rates (smoothed) and market-based inflation expectations currently shows a remarkable overshoot. Trading at 2.3%, 10y US breakeven inflation lies more than one standard deviation above the fair value estimated at 1.5-1.6% (see Figure 1), severely limiting the further upside potential<sup>4</sup>.

**Figure 1:** US 10y breakeven inflation rates



Sources: Refinitiv, Euler Hermes, Allianz Research

**Figure 2:** Decomposition of YTD yield change of US 10y Treasuries



Sources: Refinitiv, Euler Hermes, Allianz Research

<sup>2</sup> Please refer to our report *“Inflation: Back to the 1970s?”*

<sup>3</sup> For more information, see our recent report *“The Suez canal ship is not the only thing clogging global trade.”*

<sup>4</sup> For more information on our market-based inflation expectations model, please see our recent report *“Don’t judge the inflation book by its cover.”*

...on the back of taper phantasies rather than developments in the real economy: This development in market-based inflation expectations is, of course, also reflected in nominal yields. Back in August 2020, the nominal yield on 10y US Treasuries was about 75bp below our fair value estimate derived from market expectations about policy<sup>5</sup>. The recent rise from 0.60% to 1.68% shows that the reversal of the fair value undershoot follows the path of global commodity prices. However, the fact that these two price movements confirm each other does not prove that they really rely on developments in the real economy. Indeed, one could explain the recent yield movement in a quite different manner. In this explanation, markets are not primarily reacting to developments in the real economy but are playing a game of chicken with the Fed about the monetary policy decisions to come. An analysis of the nominal term structure of the US Treasury yield curve reveals that the current yield increase is not based on the expectation but on the uncertainty component of nominal yields (term premium). Based on this decomposition method, the component embodying the long-term inflation anchor has in fact hardly changed since the beginning of the year.

What has changed is the uncertainty around this expectation anchor (inflation risk premium) as well as the uncertainty about the yield-dampening effects of Quantitative Easing (the result of the imbalance of demand for and supply of US Treasuries, see Figure

2). Both elements together are comprised in the term premium, which in a term structure perspective is the sole contributor to the recent increase in US long-term nominal yields. For 10y US Treasuries, the YTD increase in the term premium is 80bp, 15bp of which is due to pricing in more inflation uncertainty (inflation risk premium) and ~80bp due to pricing out QE-induced compression. The current yield rise is thus more about market participants embracing the tapering narrative than about repricing inflation. This is also consistent with the shape of the inflation swap curve, which has inverted since the beginning of the year, with little change in the long-term values. In a way, it seems markets participants are currently front-running the Fed, trying to force its monetary policy back into a framework where the importance of QE is reduced, and the central bank's scope of action is mostly limited to managing short-term interest rates. We are not yet in a regime shift, but we currently see a regime challenge.

**The current rally on long-term sovereign yields, especially in the US, is unlikely to lead to a structural de-anchoring of inflation expectations.** In the US and the Eurozone, a rapid acceleration of realized inflation (i.e. 4% to 6% yearly rates) combined with a prolonged plateau at higher levels (i.e. 4% persistent over time) would be necessary to structurally de-anchor long-term market-based inflation expectations from current levels. However, de-anchoring could be triggered by an unexpected regime switch or loss of

confidence in monetary policy. Nonetheless, this is not our base case.

**2. The recent input price bonanza is a harbinger of galloping consumer price inflation!**

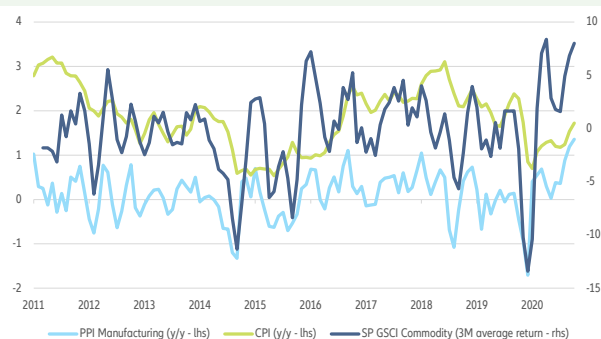
**Far from representing a new super-cycle, the recent input price bonanza represents temporary challenges around the economic restart.** Covid-19 hit commodity supply hard<sup>6</sup>: mines closed, extraction in shale oil fields was interrupted and crops were lost due to a lack of available workers. In contrast to demand, restarting supply has proven more challenging but the outlook is promising: Sanitary challenges have started to ease and producers - in reaction to higher prices - are expected to ramp up the supply of commodities as well as other parts like semiconductors that have become scarce. Nevertheless, supply will probably struggle to keep pace with the global economy shifting up another gear by mid-2021, when we forecast a vaccine-enabled, excess-savings-powered consumption boom to unfold. Similarly, heightened supply-chain pressures - including long delivery delays and price increases - are unlikely to significantly abate any time soon. All in all, this means we should expect input prices to at best consolidate at current elevated levels in H2 2021. Meanwhile in 2022, largely unclogged supply chains and normalizing demand will see input prices settle at a lower price on average compared to the start of 2021, so that positive base effects should reverse and keep a lid on price pressures.

**Figure 3: Forecasts for selected commodities**

	Spot as of April 12	Forecasts	
		2021	2022
Brent (USD/ bbl)	63.22	59	62
Copper (USD/t)	8901	8100	8400
Aluminium (USD/t)	2254	2100	2200
Natural gas - Henry hub (USD/MMBtu)	2.55	2.8	3.0

Sources: Refinitiv, Euler Hermes, Allianz Research

**Figure 4: Commodities, input prices & CPI (in %)**



Sources: Refinitiv, Euler Hermes, Allianz Research

<sup>5</sup> For more information on our long-term nominal yields model, please refer to our recent report ["What is already priced into long-term U.S. bond yields?"](#)

<sup>6</sup> Please refer to our report ["Commodities: higher demand, supply bottlenecks, but no speculation \(yet\)"](#).



### Higher input prices and a strong rebound in services demand will boost inflation in 2021, albeit not structurally.

As many corporates are already working on thin margins and others are trying to make up for last year's bad results, expect rising input prices to feed through to selling prices. This will apply more in the case of services than for goods and also prove temporary. After all, reopening economies for business in H2 2021 will see the sectors most sensitive to Covid-19 – above all tourism-related services – as key beneficiaries of the buoyant rebound in consumer spending. As demand will be particularly inelastic – i.e. consumers will be ready to accept higher prices to finally indulge in all the experiences missed out on over the past year – firms in these sectors will enjoy more pricing power and find it easier to push through higher selling prices, particularly should supply remain constrained during the early stages of the recovery. However, even with regard to these inflationary pockets, we see no reason why prices should remain structurally elevated, particularly once pent-up demand has been unleashed and supply has overcome restarting challenges.

### 3. A looming wage-price-spiral is certain to transport us straight back to the 1970s!

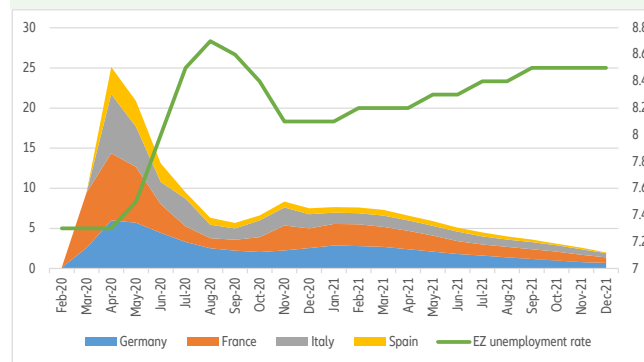
#### The sharp rebound will provide some much needed tailwind to labor markets, but cleaning up the Covid-19 economic legacy will take some time.

There is a concern that during the recovery phase, heightened competition among employers for new workers could push up wages. To compensate for higher labor costs, firms may opt to raise selling prices. Meanwhile, the additional income could fuel inflation, which in turn would see workers demand higher wages to compensate. Such a price-wage-spiral could then lead to persistently higher inflation. However, the economic reality, for better or for worse, is unlikely to live up to this picture: Even though we expect economies in the developed world to embark on a sustainable recovery path as soon as Q2 2021, the private sector is far from out of the woods. Particularly in Europe, as unprecedented policy support (fiscal, monetary & regulatory) is gradually withdrawn, we expect second-round effects to come to light at the turn of 2021-22, with

insolvencies only starting to kick-off and unemployment ticking up. In fact, we still expect around 2 million workers across the Eurozone to still benefit from job-retention schemes by end-2021<sup>7</sup>. Subdued labor market prospects in the Eurozone should keep a firm lid on wage growth (below 3%) in the medium-term. Meanwhile for the US economy – where we have seen strong jobs reports and which is likely to run notably hotter over the next few years – we expect wage growth to remain below 4%.

**While a 1970s wage-price spiral would be difficult to imagine, given labor unions' loss of influence, the risk of cost-push inflation in the medium-term needs watching.** A push for higher wages and more redistribution amid heightened social discontent, together with more/persistent state intervention in economic affairs and rising protectionist tendencies, could well exacerbate prevailing supply bottlenecks and lead to a notable and persistent acceleration in inflation.

**Figure 5: Furloughed workers in the big 4 Eurozone countries (million)**



Sources: Refinitiv, Euler Hermes, Allianz Research

**Table 1:** EM hard currency sovereign bond spreads (bps)

	Broad Money -1	Money velocity -2	Nominal GDP (3)=(2)+(1)
in USD	16.7%	-13.2%	3.6%
Fisher indices	12.2%	-12.1%	0.1%

Sources: Refinitiv, Euler Hermes, Allianz Research

#### 4. An unprecedented policy response is bound to bring structurally higher inflation!

**It's the velocity, stupid! Unprecedented policy support really is a free lunch, for now.** Unprecedented policy support (fiscal and monetary) cushioned the impact of the Covid-19 related shock on the global economy. So is this a free lunch, after all, or is higher inflation the price to pay? For a start, money supply growth is a poor guide for realized inflation. The data since the 1960s doesn't show a clear correlation—not even after 2008, when money growth accelerated and many predicted high inflation. New money doesn't automatically translate to new spending. The often neglected indicator to focus on is money velocity. If the velocity of money is constant, it would be enough to focus on its quantity, subject to the many caveats discussed above. But it was definitely not constant in 2020, irrespective of the way global nominal GDP and global broad money are measured, as shown in Table 1.

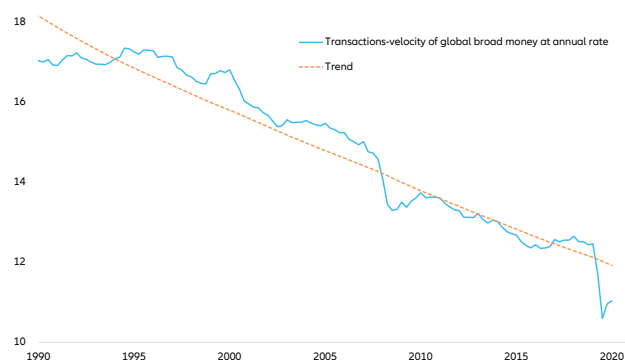
The fall in money velocity experienced in 2020 is part of the long-term trend shown in Figure 6. Both this long-term trend and its recent acceleration reflect an increase in the demand for money for precautionary purposes. Put differently, the propensity to hold idle money balances has increased. Private agents have hoarded money rather than spent it. A similar development took place during the Great Financial Crisis. Hoarding is what agents typically do when inflation expectations decline and perceived uncertainty increases. Dishoarding starts when economic agents hold more money than they desire, when there is excess liquidity in the economy. According to our proprietary estimates of the demand for money, this was the situation prevailing at the end of last year in the EMU, the US (Treasury General Account excluded), Japan and the UK, but not in China<sup>8</sup>.

However, as the current level of excess liquidity is moderate, as shown in Table 2, it should not trigger a sharp rise in the velocity of money. In the unprecedented scenario where money velocity would instantly revert to its long-term trend, it would immediately add 8pp to the growth of global nominal GDP. In front of this very implausible assumption, there is the reality of still large output gaps that could absorb a good deal of such a demand shock before pushing inflation significantly up. A gradual reversion of money velocity to the downward trend visible on Figure 6 seems to be the most likely scenario. Put differently, no matter how fast global broad money is growing, its velocity is still the missing link to inflation.

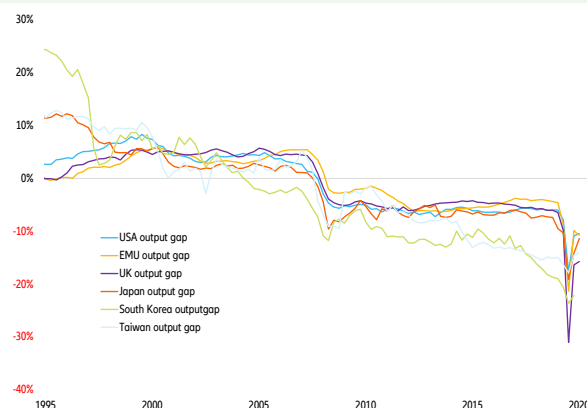
**Table 2:** Monetary imbalance at year-end 2020 (% of money supply)

2020	EMU	USA M2	Japan	China	UK
Monetary imbalance Q4	1.3%	0.5%	0.1%	-0.7%	0.5%

Sources: Refinitiv, Euler Hermes, Allianz Research

**Figure 6:** Advanced indicators for financial tensions in major EMs

Sources: Refinitiv, Euler Hermes, Allianz Research

**Figure 7:** Output gaps (in %)

Sources: Refinitiv, Euler Hermes, Allianz Research

<sup>8</sup> See our report [“Wanted: Public borrowers of last resort.”](#)

# INFLATION OUTLOOK FOR THE US AND THE EUROZONE

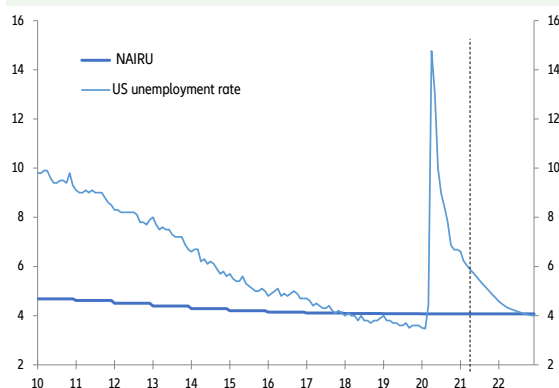
**US inflation outlook:** with the new USD1.9trn fiscal package and the USD 2.3trn infrastructure program announced in the US approved in the US, of which USD1.2bn is likely to be spent in 2021, we have revised on the upside our GDP growth scenario. We now expect US GDP growth to reach +5.3% y/y in 2021 and +3.8% y/y in 2022, following a contraction of -3.5% y/y in 2020. The confidence effect will primarily be visible in consumption and non-residential investment, which are expected at +5.5% y/y and +10.9% y/y in 2021, respectively. In this context, the reduction in the level of slack in the economy (the output gap was estimated at -3.7% of potential output in Q4 2020) will be much quicker compared with what we were expecting before. The NAIRU gap will be closed as early as end-2022. This tightening of job market conditions, together with go-

vernment plans to push for increases in the minimum wage, are likely to maintain the progression of average hourly earnings at an elevated level, just below 4% y/y by 2022. The imposed doubling of this minimum wage, implemented very quickly, could have potentially reactivated a wage-inflation loop, with possibly devastating consequences in terms of the stability of interest rates, but this scenario has been avoided.

Our CPI inflation equation, when integrating the reduction in the output gap, accelerating energy-commodity prices and rising salaries, points toward a significant increase in inflation, albeit a temporary one. We expect CPI inflation to overshoot the 3% y/y level in Q2 2021 compared with 1.7% y/y in February 2021. However, this uptick should mainly reflect a strong base effect, while

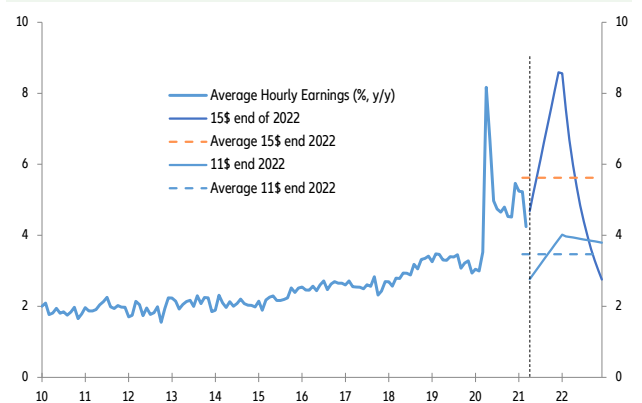
long-term drivers of inflation will allow a stabilization thereafter toward a medium-term level of 2% y/y. We expect US CPI inflation to come in at 2.5% y/y in 2021, 2.0% y/y in 2022 and 2.2% y/y in 2023. In this environment, the two-year average performance of inflation should be above 2% y/y starting at the beginning of H2 2022 instead of late H2 2022 in our previous scenario. The Fed could therefore be incited to announce a tapering even earlier, which will materialize in a progressive reduction in the monthly amount of securities purchases in H2 2022. From H2 2023 onwards, the Fed could opt for a first rate hike. The continuing ultra-expansive stance of fiscal policy should allow the US central bank to undertake a normalization of its monetary policy.

**Figure 8:** NAIRU gap in the US (%)



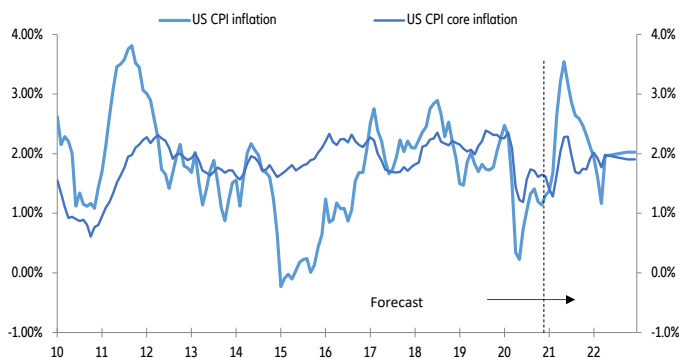
Sources: IHS, Euler Hermes, Allianz Research

**Figure 9:** Average hourly earnings with different scenarios of convergence toward levels of federal minimum wage from USD7.5 today



Sources: IHS, Euler Hermes, Allianz Research



**Figure 10: CPI inflation in the US**

Sources: IHS, Euler Hermes, Allianz Research

**Table 3: Baseline scenario – inflation forecasts for the US and Eurozone (%)**

Inflation (%)	2019	2020	2021	2022	2023
<b>US</b>	1.8	1.3	2.5	2.0	2.2
<b>Eurozone</b>	1.2	0.3	1.4	1.2	1.4

Sources: Euler Hermes, Allianz Research

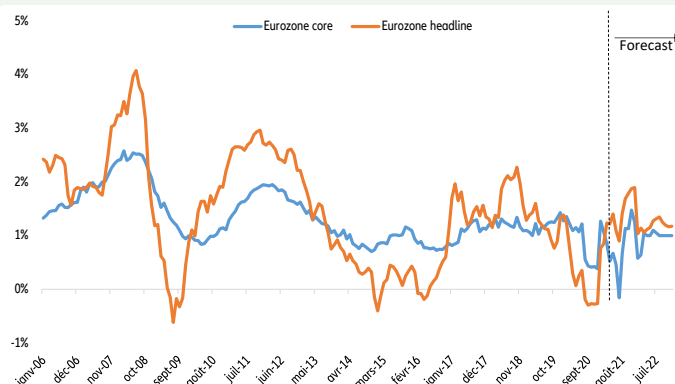
**Eurozone inflation outlook:** meanwhile, the Eurozone economy is in for a roller coaster ride in 2021, moving at a rapid pace through the entire economic cycle palette, from a double-dip recession at the start of the year to a technical rebound from mid-Q2 onwards as restrictions are gradually lifted. This will be followed by a vaccine-driven consumption boom in the second half of the year amid receding economic uncertainty. We forecast GDP growth of +4.0% for both 2021 and 2022, while acknowledging elevated downside risks for H1 2020 should the lockdown be tightened further and/or be prolonged and for thereafter should the vaccination rollout fall behind our expectations.

Overall, we expect the Eurozone economy to recover to pre-crisis GDP levels in H1 2022, whereas some member states, including Spain and Italy, will need an additional year to heal. Inflation rates – headline as well as core –

will reflect this volatile economic ride but at the same time remain subject to strong base effects as well as seasonal factors. Input price increases will prop up prices in the first half of the year. However, price pressures will shift into overdrive only in H2 2021 as progress on the vaccine front sees the Eurozone economy register strong catch-up growth. As economic uncertainty recedes, with the risk of another lockdown off the table, we expect households to unleash their pent-up demand and supercharge GDP growth by drawing down their precautionary savings – albeit not fully. Out of the EUR530bn in Eurozone household savings build-up over the Covid-19 crisis, we expect only EUR180bn (1.5% of GDP) to be unleashed in 2021. As a result, Eurozone inflation will briefly rise towards the ECB's inflation target in Q4 2021 – headline (+1.9%/y/y) but also core (1.5%/y/y). But don't expect the ECB to cry victory yet. After all, this acceleration should prove to be temporary and

any calls for monetary policy tightening at that stage would be clearly premature. Ongoing slack in the economy, particularly in the labor market, should keep a lid on wage growth and in turn underlying pricing pressures.

Nevertheless, expect it to be a delicate communication act for the ECB to justify the ongoing implementation of emergency policy measures, particularly once German headline inflation rises above 3% in late 2021. Overall, we therefore expect headline inflation to average at +1.4% in 2021, after +0.3% in 2020, but to remain stuck below +1.5% in the medium-term (+1.2% in 2022 and +1.4% in 2023). In this context, we expect the ECB to maintain an accommodative policy stance, with PEPP purchases to be continued until at least end-March 2022, after which the traditional QE program APP will take the lead.

**Figure 11: Eurozone inflation – headline vs. core (% y/y)**

Sources: Refinitiv, Euler Hermes, Allianz Research

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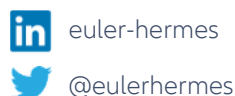
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