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CIO Viewpoint

Inflation spikes prove more durable when the chips are down

Investment Solutions

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Semiconductors, components powering everything from mobile phones to refrigerators and cars, have begun to have an economic, as well as technological impact. Their shortage accounts for a large share of price rises in the US, and illustrate broader supply chain problems just as consumers start to open their wallets in a post-pandemic spending splurge.

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For more than a decade, monetary policy makers wondered where inflation had gone. Since April, US inflation has risen as the country emerged from lockdowns and consumers began spending their savings. Consumer inflation in the US rose 0.9% in June alone, bringing the annualised increase to 5.4% compared with a year earlier. Annualised, last month's inflation would be the highest in three decades. Our outlook calculations suggest that US inflation will remain high through the rest of 2021, peaking in November and December, before tailing off into 2022 (see chart 1).

Key takeaways

- A semiconductor shortage has increased car prices, pushing US inflation to three-decade highs
- We see no evidence that inflation is spreading to other parts of the economy
- Expecting US inflation to prove transitory, the Fed continues to watch job numbers while some central banks are already acting
- As long as inflation pressures remain limited, real yields should move against the US dollar, depreciating the currency.

When the chips are down

A renewal of spending on air fares, hotels and restaurants is a natural consequence of economic reopenings, and also accounting for some of the price pressure. Demand for old and new vehicles drives the rest. Resurgent demand and shortages of semiconductor chips have seen wholesale prices of second-hand vehicles gain 34.3% over 12 months, with new car prices up 18% over the same period.

Vehicles are sensitive to semiconductor supply. On average, a new car contains 1,400 semiconductors used in everything from parking sensors, to cruise control and touch screens, while hybrid or electric vehicles can require as many as 3,500 chips. The shortage of semiconductors has forced carmakers including Ford Motor Company to idle output.

It takes months to increase semiconductor production capacity and manufacturing is highly concentrated. Three-quarters of the world's supply comes from China and East Asia, while production of the most advanced chips is even more concentrated with 92% made in Taiwan and the rest in South Korea.

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Not universal

We see nothing to suggest that the factors driving inflation are spreading to other areas of the economy, or other countries. More persistent inflation would be visible everywhere. At the moment, inflation is limited to specific US sectors and normalising in other markets around the world (see chart 2).

Neither China nor Israel, the countries leading recoveries globally, are experiencing inflationary spikes. Core consumer price inflation in Israel was 1.5% in May, and 1.7% in China last month. China's inflation may not yet reflect the government's efforts to shift to a consumer-spending led economy, rather than its historically manufacturing-driven model. China's companies may be experiencing cost increases linked to the prices of commodities, that they are not yet passing on to consumers.

Global inventories and supply of raw materials and logistics are low in everything from steel and cotton to timber and shipping containers. That suggests numerous economic bottlenecks in the short term which explain higher prices, but there is no fundamental global lack of capacity to eventually respond to recovering demand. That suggests supplies can and will recover, limiting inflation's increases.

Targets and policy responses

In other markets, core inflation still trails central banks' targets. Eurozone consumer inflation was 0.9% in June while in Switzerland and Japan it trailed still further, at 0.3% and -0.3% respectively.

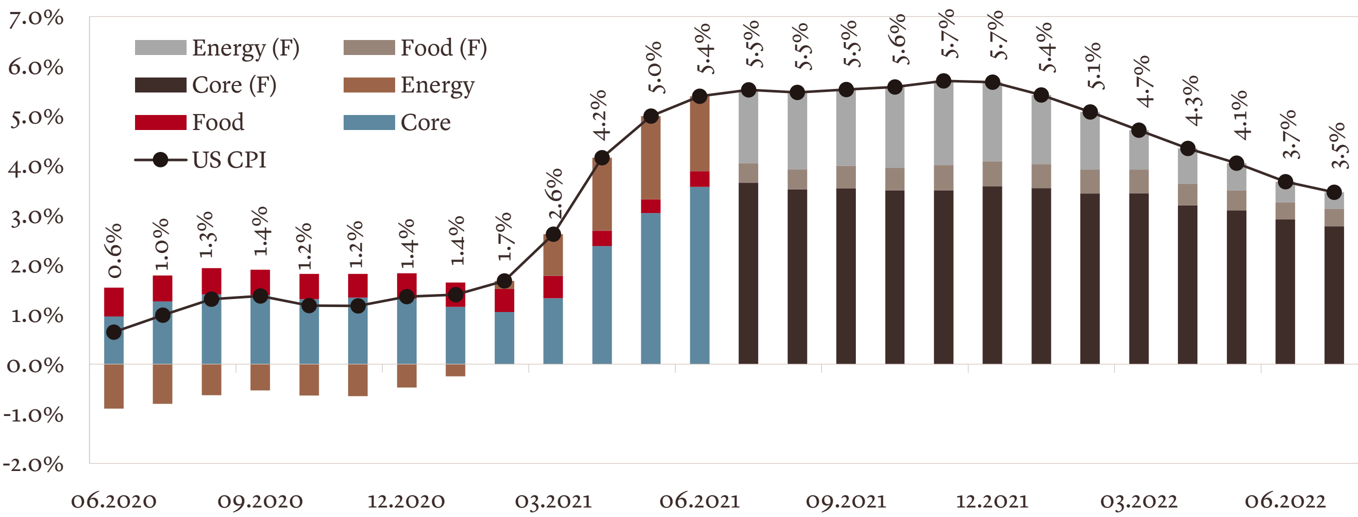
After the Fed's shift to average inflation targeting, the European Central Bank moved its goal posts last month. The ECB replaced an inflation target of "close to but below 2%," with a "symmetric 2%." Both positive and negative variations from the target, said the ECB, are "equally undesirable." Historically of course, eurozone inflation was always below, rather than even close to 2%.

Not every economy can afford to be so relaxed about inflation. For some emerging economies, with a history of volatile inflation, central bankers fear a vicious circle of depreciating currencies and even higher inflation, fuelling inflation expectations and undermining consumer and investor confidence. This said the difference now is that emerging central banks' policies have become much more credible in the last two decades.

Transitory but actionable

Russia's central bank forecasts full-year inflation of 6.15%, and last month increased its rate by 50 basis points to 5.5%. On 24 June, the Banco de México increased interest rates by 25 basis points, to 4.25%, to keep expectations under control. Even as the central bank agreed with its nearest northern neighbour that inflation should prove 'transitory,' it also said that the scale of recent price rises cannot be ignored. Brazil's central bank has already hiked its policy rates three times this year, from 2% to 4.25%, and will likely continue, possibly to as high as 7%. Within Latin America, Chile may be next to hike, but from a very low starting point.

1. Lombard Odier US inflation outlook adjusted for oil prices



Source: Lombard Odier calculations

In the developed world, some central banks are already taking steps to either wind down emergency asset purchases or raise interest rates. Australia's central bank said on 6 July that it will taper asset purchases from September, and in Norway, policymakers plan to begin raising rates that same month.

Full employment plans

In the US, the Fed continues to underline that it is looking at jobs to assess the solidity of the recovery. As unemployment benefits scale-back in the months ahead, it will watch whether this translates into more workers returning to industries suffering from labour shortages. In May, the US had a record 9.2 million job positions open.

"Even after this supply comes," Jerome Powell, Fed Chair, told a Congressional committee last week, "it is still likely that we will still be short of maximum employment," adding "that is why we don't see that is time to raise interest rates now."

We expect the Fed to continue with its crisis positioning and announce as early as next month a plan to start tapering emergency purchases in 2022, and begin raising interest rates in the first half of 2023.

Currency implications

Economic theory tells us that when domestic prices rise, a currency should depreciate to offset the competitive disadvantage. Over the past three decades, the relationship between the trade-weighted (TW) US dollar and US consumer price inflation has followed this pattern, particularly against other developed market currencies.

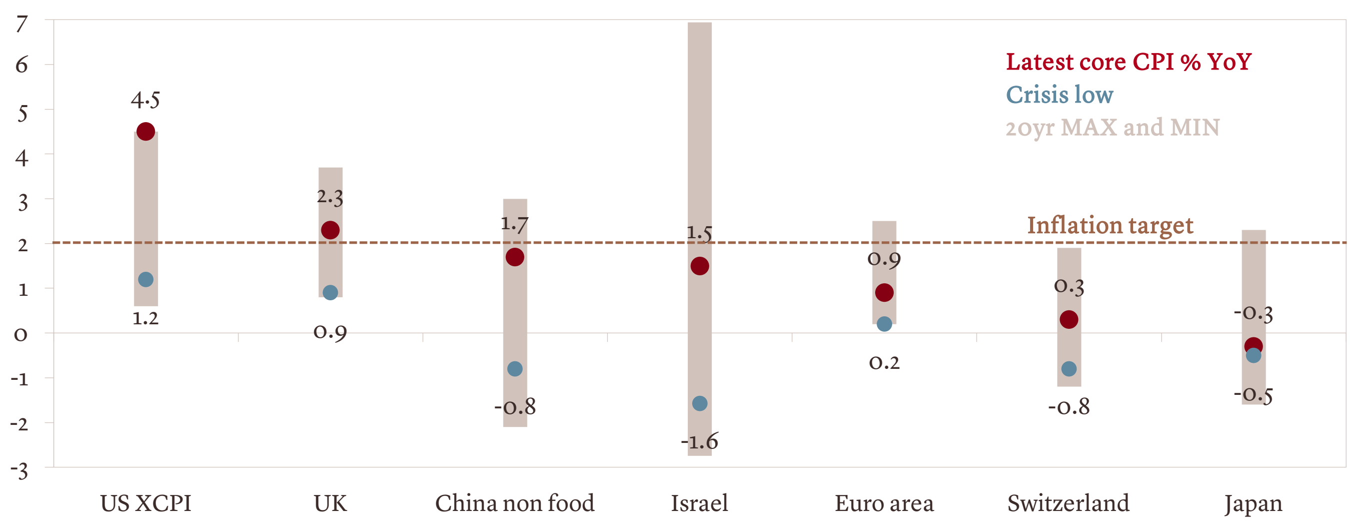
Because central banks' explicit inflation mandates mean that changes to inflation trigger interest rate moves, it is more appropriate to look at the relationship between the exchange rate and real yields (nominal yields deflated by inflation) or the real yield differentials.

Such relationships, affected by the many factors bearing on currency markets, have broken down in the past. At the inception of the euro, for example, as well as when the ECB initiated negative interest rates and introduced quantitative easing. Still, the gap between real yield spreads and the dollar is central to our expectation for a weaker US dollar – alongside a strong global recovery and growth rotating towards Europe.

We believe that the recent surges in inflation, proving transitory, will not deter the Fed from sticking to its goal of a fuller job market recovery and its announced timetable. In this case, real yields should move against the US dollar, assuming inflation does not become more universal, and the US currency will depreciate as higher inflation erodes the value of the exchange rate.

2. Not a global phenomenon at this stage

Global core CPI – excluding food & energy (in % YoY)



Sources: Bloomberg, Lombard Odier

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