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THEMATIC

In this report:

Malaysia – Transitory inflation during recovery phase

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Malaysia

Transitory inflation during recovery phase

A low base, supply bottlenecks and pent-up demand are the main drivers for higher inflation in the US. The surge in US consumer prices has been described as transitory. For inflation to be transitory, we are of the view that the transitory period should be between 6 and 9 months. However, the Federal Reserve, who sees the current high inflation as transitory, has not precisely defined the term.

In our view, the Fed is unlikely to raise rates in response to the inflation surge. The Fed is more likely to start repricing the policy rate sometime from 2023 onwards as opposed to 2022. It will instead start tapering in 2022. While we are not expecting any rate hike to happen until 2023, we will continue to focus on the supply bottlenecks and demand. We hope to see pressures from supply bottlenecks and demand to be broadly resolved by 2022. If that does not happen, it will undermine the Fed's and our transitory inflation thesis. Certainly, the monetary policy might have to adjust earlier.

- US consumer prices rose more than expected in May by 5% y/y, the highest since the summer of 2008, when oil prices were skyrocketing. Excluding food and energy, core consumer prices rose 3.8% y/y, the highest pace since 1992. A third of the increase was due to a sharp 7.3% rise in used car and truck prices.

- However, the surge in consumer prices has been described as transitory. What is the meaning of this? It means the current upward pressure on consumer prices should be brief or short-lived. We are of the view that the transitory period should be between 6 and 9 months.

- The Federal Reserve, who sees the current high inflation as transitory, has not precisely defined the term. Its notes only revealed that it generally expects elevated inflation for the remainder of 2021 and foresees inflation to moderate in 2022. It also implies that elevated inflation will stay for several more months. However, not all Fed policymakers are of the same view. Some believe that inflation may linger further into 2022.

- We have factored in several months of elevated prices. The comparison to last year's weak levels — when the economy was mostly shut down — is a factor. The low -base effect is one important driver of the current surge in inflation. Driven by subdued 2020 inflation, we are seeing inflation catch-up in 2021 and normalising in 2022. This would mean that although inflation may remain elevated, the base rate effect will calm inflation over the coming months, just as comparatively, inflation picked up off the low levels towards the end of 2020.

- The other narrative on the upward inflationary pressure comes from the supply bottlenecks. As we are seeing in many countries, the main driver of inflation is supply bottlenecks. These take place as the economy reopens. Paired with robust consumer demand i.e. "pent-up demand", these will put upward pressure on prices. Again, we are of the view that these unusual disruptions to the economy will start to moderate in 2022 as global supply chains work out their current issues and pent-up demand fizzles.

- Driven by the narratives of low base, supply bottlenecks and pent-up demand, currently there is no expectation that the Fed will raise rates in response to the inflation surge. The Fed is more likely to start repricing the policy rate sometime in 2023 onwards as opposed to 2022. Instead, the Fed will start tapering in 2022.

- n our view, the first step towards any change on the Fed's outlook would be when it publicly discusses the decision to roll back the US$120 billion in Treasury and mortgage securities it buys each month. This is the quantitative easing programme that was designed to create liquidity and keep interest rates low.

- Once the Fed has started to discuss its quantitative easing programme, we expect the Fed to adopt a wait-and-see stance for a few months before beginning a gradual rollback on its bond-buying until it gets to zero. We expect the Fed to first talk about tapering bond-buying at its Jackson Hole Economic Symposium in late August. Any actual reduction to the size of purchases will be either in 2021 or early 2022. Only after that can we expect the Fed to start considering raising its target federal fund rate from zero.

- While we are not expecting any rate hikes to happen until 2023, given that base rates are expected to be a key driver, if inflation does not show a downward trend over the coming months as we start to compare with higher levels from the corresponding months in 2020, that may prove to be a concern for the Fed.

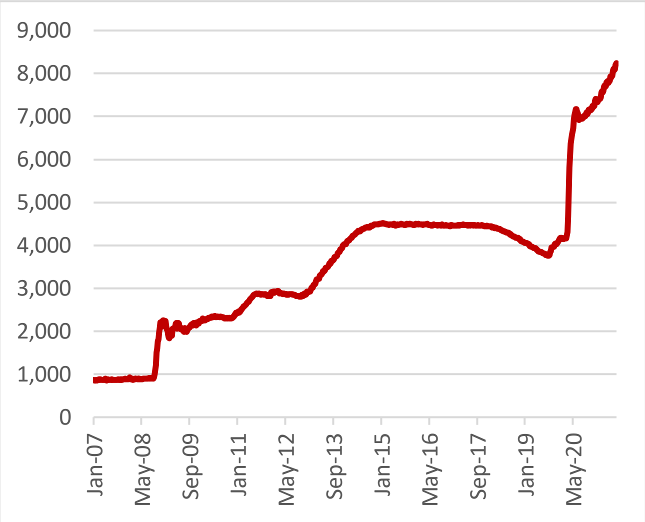
- And given that supply bottlenecks are seen as a key inflation driver, we hope to see these broadly resolved by 2022. What happens if this trend supply bottleneck continues added with strong demand? More so with the US economy recovering faster and inflation moving quicker? It may not be as transitory as we all expect, especially with the global economic recovery and record levels of fiscal and monetary support. It would slow down the process for inflation to trend back to the Fed's 2.0% inflation target by early 2022.

- Besides, the pricing power in Covid-benefited sectors is expected to weaken although this has yet to materialise. However, these Covid-recovery sectors represent just 4% of the total CPI while the Covid-benefiting sectors comprise 12% of the overall price index. That leaves most of the CPI untouched.

- In summary, for inflation to prove transitory, we would need to witness a broadly declining trend from now, but with inflation remaining higher than normal into early 2022. If that does not happen, it will undermine the Fed's transitory inflation thesis. Certainly, the monetary policy might have to adjust with a corresponding impact on markets and appropriate investment strategies. The adjustments may not be pleasant, as many believe any rate hike is still several years out currently.

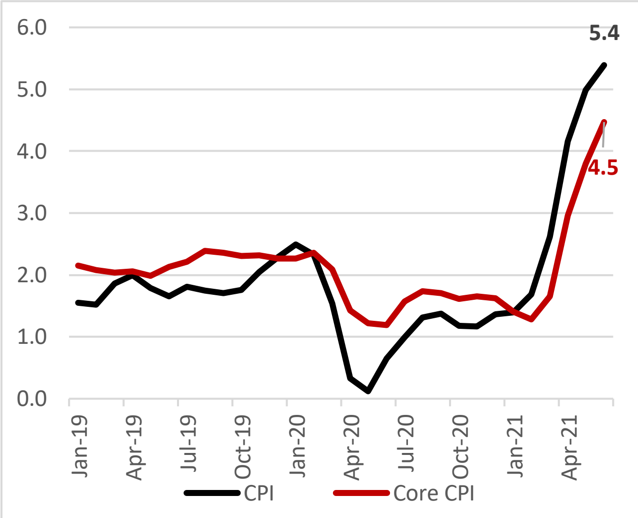
- Looking ahead, the third quarter is going to be key for our assessment of whether we are entering a new period of persistent inflation. Inflation is proving sticky and stretching the definition of transitory, making it increasingly hard for us as well as the Fed to convince investors that its transitory narrative remains valid.

Chart 1: US Fed Balance Sheet (US$ bil)



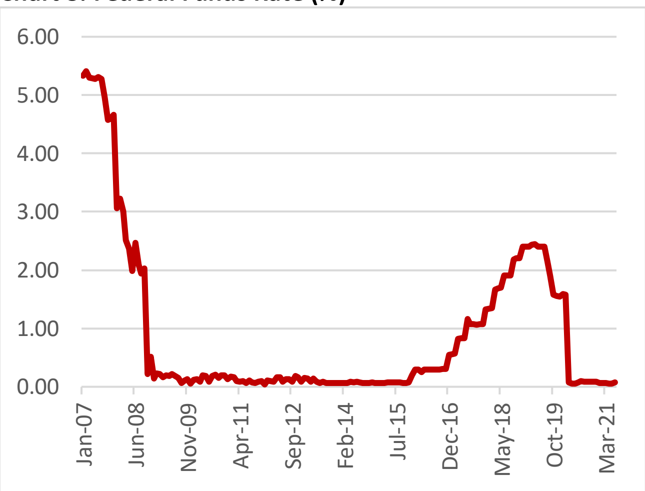
Source: CEIC/AmBank Research

Chart 2: CPI & Core CPI (% y/y)



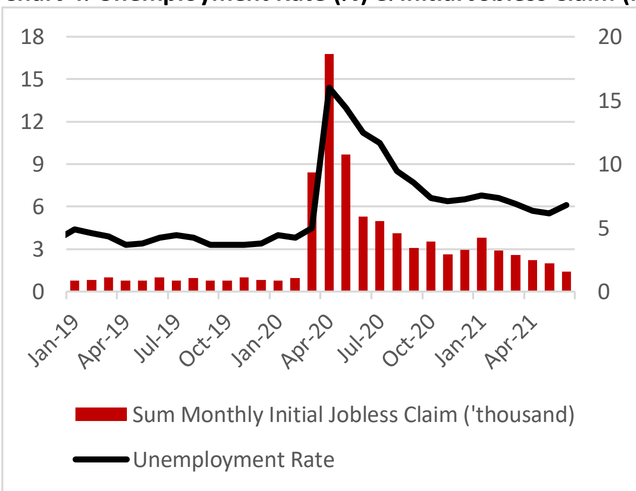
Source: CEIC/AmBank Research

Chart 3: Federal Funds Rate (%)



Source: CEIC/AmBank Research

Chart 4: Unemployment Rate (%) & Initial Jobless Claim (K)



Source: CEIC/AmBank Research

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