EDITORIAL

THREE HEADWINDS TO GROWTH

In his testimony to a commission of the US Senate, Jerome Powell has acknowledged that inflation is less transitory than considered hitherto, adding that, as a consequence, a faster tapering seems warranted. Despite this hawkish tone, the reaction of US Treasuries was muted. This may, amongst other things, reflect concern about how the pandemic might evolve. The new Omicron variant undeniably represents an uncertainty shock for households and companies. It comes on top of a negative supply shock that is already a clear headwind to demand. It clearly makes the task of central banks more complicated than ever when deciding how much of a monetary headwind they can create.

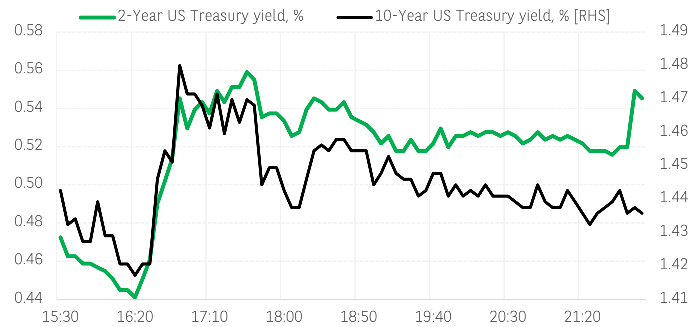
'Everything is transitory, including life'. This (obvious) point was recently made by a US senator when introducing his question to Jerome Powell about the transitory nature of inflation[1]. The Fed Chairman acknowledged that inflation may very well be elevated for longer and hence less transitory than considered hitherto. Given that the economy is strong, he added this would justify a faster tapering than signaled following the latest FOMC meeting[2].

Unsurprisingly, markets reacted instantaneously to this more hawkish tone with 10-year Treasury yields moving about 6 basis points higher and the 2-year yield increasing slightly more, about 11 basis points (chart 1)[3]. Thereafter, the short end of the yield curve fluctuated in a narrow range. More surprising was that after this knee-jerk reaction, the 10-year yield started drifting lower, leaving the yield at the close of Wall Street, barely above the level before Powell had spoken. This could reflect three things. One, investors might feel uncomfortable about the accelerated tapering and the increased likelihood that official rate hikes would come sooner rather than later. They probably fear that the economy would react quickly and quite negatively to such a policy tightening. Under such a scenario, the yield curve inevitably flattens. Two, investors are less concerned about the economy but fear that the more hawkish stance of the Fed would weigh on the equity market. Under such an outcome, demand for safe assets would rise, causing an increase in bond prices and lower yields. The muted reaction of the bond market to Powell's comments could reflect an anticipation of this scenario. Three, market participants may fear that, should the number of new cases of the Delta variant continue to increase, this might end up weighing on growth in the short run. It looks like we are already moving in that direction in several European countries, hence the concern about what might happen in the US. Chart 2 shows, based on Google mobility data, that in Europe, footfall in retail and recreation has declined quite significantly in recent weeks.[4] It remains to be seen whether this will weigh on aggregate spending, but it should clearly have sector effects – think of the negative impact on the leisure and hospitality sector – and could favour online purchases over in-store shopping. It is to feared that the new variant, Omicron, will reinforce these developments, although this depends on its transmissibility, on the effectiveness of existing vaccines and whether it causes severe disease or not. When the news about this variant started to spread, markets reacted by revising the growth outlook, witness the decline in oil prices – reflecting an expected drop in demand – and a weakening of the dollar versus the euro – reflecting the view that the Federal Reserve may be less inclined to tighten quickly. The decline in bond yields also points in that direction.

Omicron undeniably represents an uncertainty shock to the economy and raises the concern that, once again, the return to normality may take longer than expected. Research shows that such an uncertainty shock weighs on investment spending – companies preferring to wait until they see more clearly – but household spending, in particular on durable goods, can also suffer when households fear a hit to the labour market. At the current juncture, the reaction will probably be more muted, based on the hope that, again, successful vaccines will

1. *"Coronavirus and CARES Act",* Testimony of Jerome H. Powell before the Committee on Banking, Housing, and Urban Affairs, US Senate, 30 November 2021.
2. This was held on 2 and 3 November 2021.
3. The time shown on the chart is CET. The testimony started around 16.00 CET.

US TREASURY YIELD (IN %), 30 NOVEMBER 2021 (CET)



SOURCE: BLOOMBERG, BNP PARIBAS

CHART 1

> For households and companies, the Omicron variant thus far represents an uncertainty shock. It comes on top of a negative supply shock that is a clear headwind to demand. It makes the task of central banks more complicated than ever when deciding how much of a monetary headwind they can create.

quickly be developed if need be. However, for households and companies, this uncertainty shock comes on top of a negative supply shock – supply disruption, a huge increase in producer prices and, albeit to a lesser degree, consumer prices – that is a clear headwind to demand. It clearly makes the task of central banks more complicated than ever when deciding how much of a monetary headwind they can create. Not only is the question of how transitory inflation is, there is also the even more difficult one of how transitory the impact of the new variant might be.

William De Vijlder

RETAIL AND RECREATION MOBILITY
(7-DAY MOVING AVERAGE, % FROM BASELINE*)

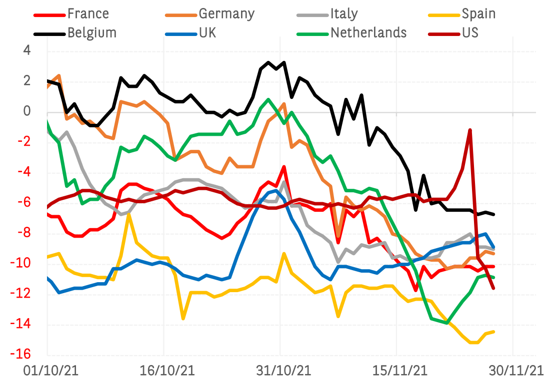
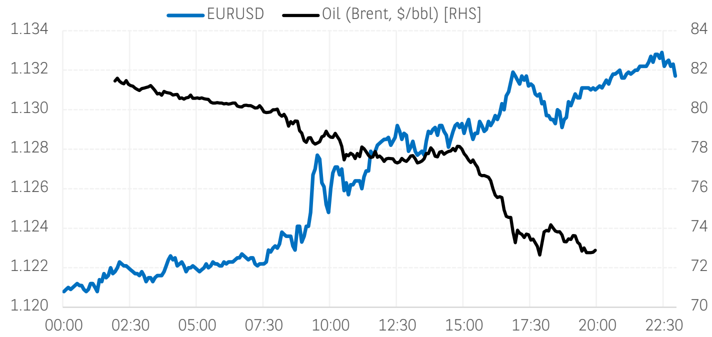
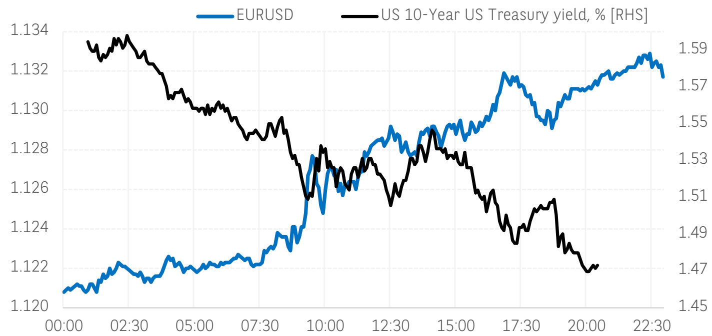


CHART 2

SOURCE: GOOGLE, BNP PARIBAS

FINANCIAL MARKETS ON 26 NOVEMBER 2021 (CET)





CHARTS 3 & 4

SOURCE: BLOOMBERG, BNP PARIBAS

* Google Mobility Reports show how visits and length of stay at different places change compared to a baseline. The baseline is the median value, for the corresponding day of the week, during the 5-week period Jan 3–Feb 6, 2020. A figure of negative 30% indicates that traffic was down 30% compared to a baseline. The reports show trends over several weeks with the most recent data representing approximately 2-3 days ago—this is how long it takes to produce the reports. In order to smooth the series, we use a seven-day moving average of the raw data in the Google Mobility Reports.

"Price increases have spread much more broadly in the recent few months across the economy and I think the risk of higher inflation has increased (...) So I think the word "transitory" has different meanings to different people. To many it carries a sense of short-lived, we tend to use it to mean that it won't leave a permanent mark in the form of higher inflation. I think it is probably a good time to retire that word and try to explain more clearly what we mean."

"But clearly the risk of more persistent inflation has risen and I think you've seen our policy adapt and you'll see it'll continue to adapt. We'll use our tools to make sure that higher inflation does not become entrenched."

"Remember that every dollar of asset purchases adds accommodation to the economy but at this point the economy is very strong and inflationary pressures are high and it is therefore appropriate in my view to consider wrapping up the taper of our asset purchases, which we actually announced at the November meeting, perhaps a few months sooner. And I expect that we will discuss that at our upcoming meeting in a couple of weeks..."

"And also we've said that we do see these inflationary pressures as now being sustained well into next year. We do expect them though to subside in the second half of next year and by the way that is very widely held in the forecasting community which admittedly has much to be humble about."

Some of J. Powell's comments at US Senate hearing on 30 November 2021 (Source: https://www.youtube.com/watch?v=_D97jdDzznk)