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RESEARCH NOTE

Inflation Hits a Fork in the Road

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Omicron will not be the last variant that surfaces, especially with about half the Greek alphabet still unused. Much is still unknown about the risks, but they add another level of complexity to the outlook. Meanwhile, **inflation pressures are looking more durable, widespread, and worrying, particularly in the U.S., even though they remain more nuanced in other parts of the world.**

The new variant risks are making bottlenecks more persistent, but they can also prompt delays in consumption, depressing growth. Our outlook remains constructive for risk assets, but we will keep a close watch in the coming weeks on emerging patterns of transmission, virulence, and vaccine resistance.

A great divergence is coming into view on inflation, with the U.S. set to stand apart. Price data formerly known as transitory was supposed to be a function of base effects and shipping bottlenecks. The role of demand was underappreciated, and it came roaring back in the U.S. due to unprecedented levels of fiscal support and surging incomes, adding to reignited animal spirits, with consumers eager to celebrate life without constraints. This has allowed firms to pass higher input prices to consumers while maintaining margins, although we still expect these pressures to moderate by the second half of 2022.

Despite these risks, the overall global economic recovery remains strong. Pent-up demand is providing an important tailwind, amplifying some unusual ingredients for a lasting expansion at this stage of the recovery. Household and corporate balance sheets are healthy, consumer confidence and saving buffers are high, investment plans are buoyant, credit is abundant, and policy remains accommodative.

There appears to be a lot of momentum behind growth, and **even Japan is set to benefit from a sizable fiscal spending plan** next year. Outside the U.S., inflation should ease quickly next year, trending back to longer-term averages as global energy prices fade. The more moderate fiscal injection in Europe leads us to expect a less-worrying inflation trajectory there. In China and Emerging Asia, inflation risks are likely to be tempered by the weaker consumption recovery.

Adjusting for these new pressures, **our Brave New World scenario remains at 60% odds, with strong growth that will not be cut short by inflation jitters.** We mark-to-market our outlook to incorporate the faster taper and an accelerated trajectory of rate hikes through 2022, but we remain firm in our belief that financial conditions will stay accommodative in the next 12-18 months, supportive of risk assets and, at least in the short term, the U.S. dollar. This environment will likely also favor cyclical sectors, high yield, and commodities. Bouts of volatility triggered by viral fears will likely continue to resurface but should provide attractive buying opportunities as the basic end-point is unlikely to be derailed.

Our alternate Perfect Storm scenario remains a prominent risk, especially if U.S. inflation continues to accelerate. How much slack remains in the labor market is unclear, as participation remains stubbornly low. The red-hot housing market and intensifying rental inflation present additional risks. To top it off, more expansionary fiscal spending is expected in the coming months. **Even the Fed has adjusted, if not flinched, amid the latest price data,** at least making noises about the importance of fighting inflation. But, given our expectations of dissipating inflation, we keep this scenario only at 30% probability.

The risks of a significant disappointment of demand remains minimal, particularly for advanced economies, given the levels of fiscal support unleashed and stocks of savings that remain unspent. Thus, **we continue to assign a 10% probability to our Gravity Prevails scenario.**

IMPORTANT INFORMATION

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