Inflation drivers and equity markets

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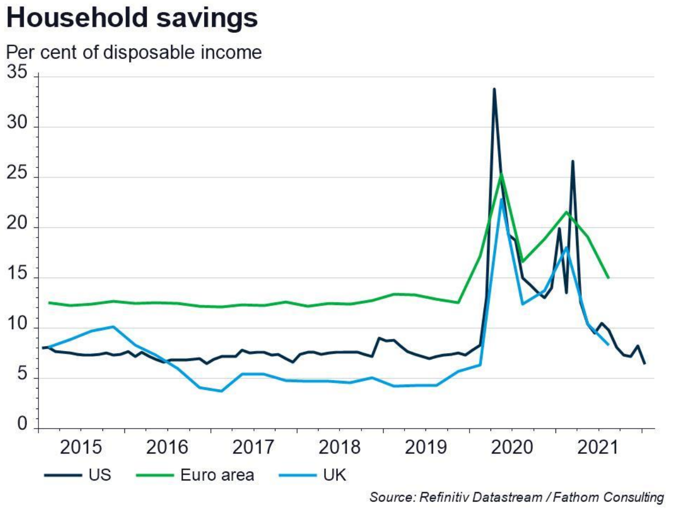
In its most recent Global Economic and Markets Outlook (GEMO), compiled in December 2021 and covering Q1 2022, Fathom probed the underlying conditions that are sustaining high inflation, and how inflationary traits manifest in the financial markets.

One important question is whether the excess savings created by fiscal support, and by the inability to consume due to restrictions, have now been spent. Does there remain a potential for spillovers on inflation and growth? The latest data suggest that saving patterns are quickly mean-reverting to their pre Covid levels, particularly in the UK and US. However, the stock of excess savings remains largely intact and, for it to fall, saving rates would need to dip below trend for a significant period of time or into negative territory. Overall, the potential for excess savings to spill over onto the wider economy remains. However, we also believe that a share of consumers may have used their excess savings to alter their work-leisure patterns, for instance by pursuing early retirement.



The wall of liquidity generated by large fiscal and monetary responses in the aftermath of the COVID pandemic was compounded by a boost in confidence as Americans exited lockdowns early in the recovery. These trends disproportionately helped equity markets recover and reach new all-time highs. However, as inflationary worries have since taken hold, consumer confidence has suffered, and questions have started to emerge over the sustainability of current market valuations if some of the COVID policy measures were to be withdrawn too quickly.

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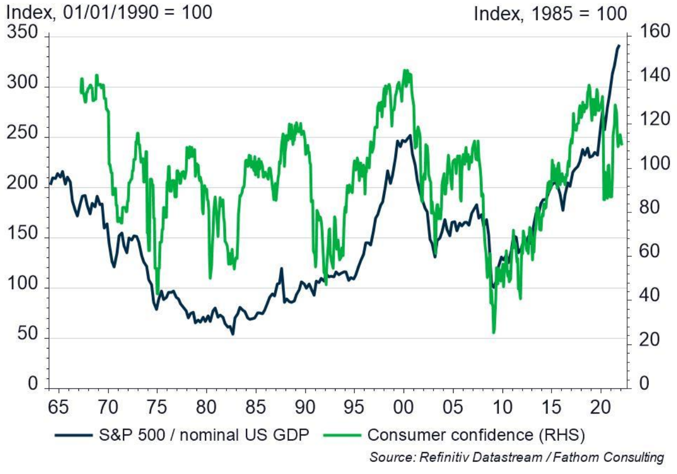
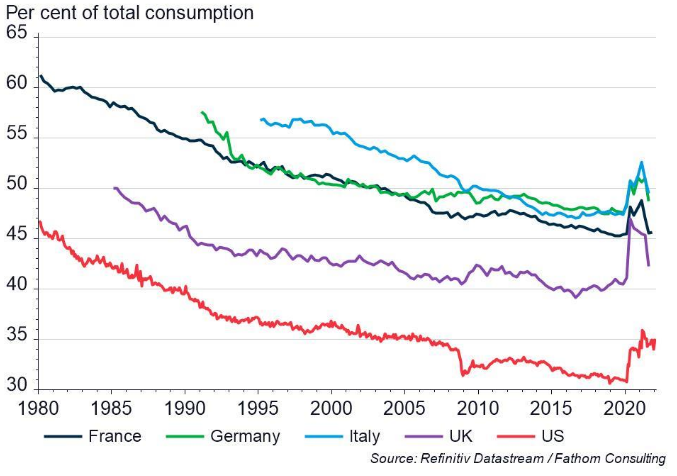
US equities and consumer confidence



The surge in equity markets hides a sectoral divergence in fortunes that is mirrored in economic trends. The COVID pandemic has highlighted an interesting shift in the spending patterns of consumers towards consumption of goods and away from services. This shift is apparent across a number of developed economies. A similar divergence also manifests in equity prices, where the MSCI world retailing index is up 10% while the consumer services index is down 16% relative to the world market. While data from Europe suggest that an increased preference for goods over services may be a transitory phenomenon, data from the US have so far failed to normalise.

Goods consumption



Another key question gripping markets is around inflation and how quickly, if at all, it might normalise back closer to central banks' targets. The labour market is a key part of this puzzle, and it is increasingly tight under a range of different metrics. Labour force participation has fallen sharply, by 2.5% in the US. Fathom's analysis attributes the drop to older age groups choosing to retire early, a pattern that is also observed across other G7 economies.

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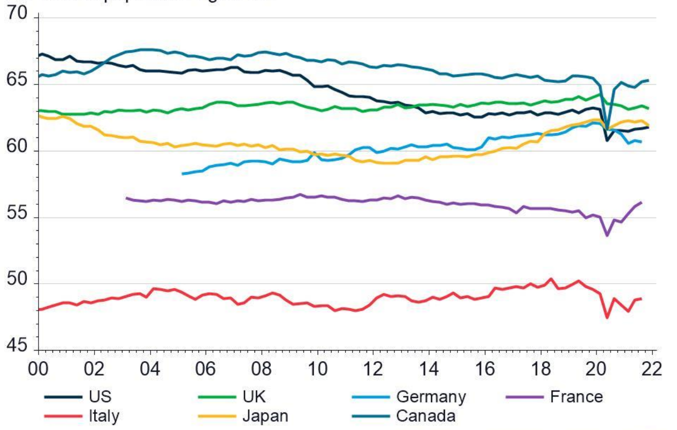
Major economies labour force participation

Per cent of population aged 15+

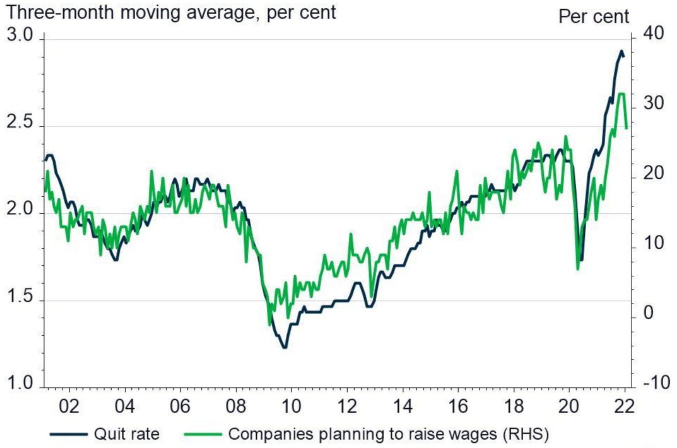


Source: Refinitiv Datastream / Fathom Consulting

The voluntary quit rate — another metric of labour market tightness — is also very high suggesting that workers are not worried by the prospect of looking for another job, partly as a result of the strength in the economy and partly thanks to the excess savings accumulated during the pandemic. As a result, firms are planning to raise wages to deter people from quitting, retain talent and meet demand. In Fathom's view, as savings dwindle, virus fears recede, and wages rise, some workers will return to the labour force and reverse some of the labour tightness observed. However, some will not; particularly those who have chosen to exit the labour force through early retirement. This so-called 'big quit' will have a lasting impact on potential output, implying greater inflationary pressure for a given level of demand.

US job quit rate and wage expectations

Three-month moving average, per cent



Source: Refinitiv Datastream / Fathom Consulting

Compounding these structural uncertainties around the labour market and consumption patterns, cyclical forces of strong demand are further exacerbating inflationary pressures. Traditionally, these cyclical forces have favoured commodity-producing countries and tend to be reflected in relative equity performance.

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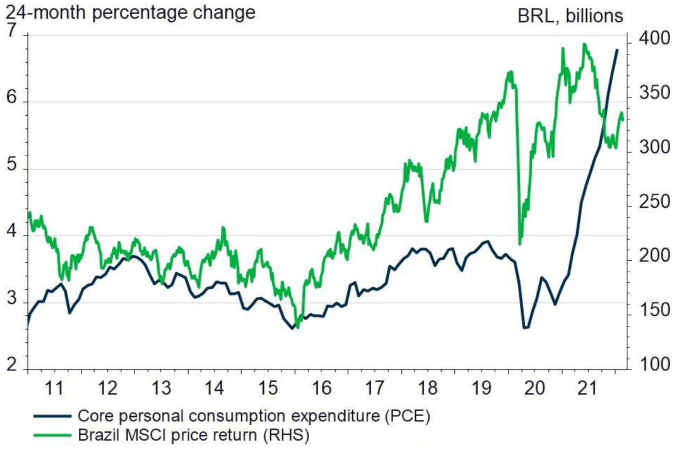
US inflation and commodity producers' equities



Source: Refinitiv Datastream / Fathom Consulting

In the upcoming Q2 2022 GEMO, Fathom explores the extent to which inflationary pressures may be easing, the probable actions of central banks and scenarios for the corresponding economic and financial market showdowns. Watch this space.

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