3RD JUNE 2021

THE CENTRAL BANKS TRAP

In the face of a strong recovery and growing signs of an upturn in prices, Central Banks in Europe and the US will have a tough time to follow the narrow path to normalisation, stuck between the growing pile of debt on the government balance sheet and emerging signs of inflation.

Following one of the steepest and shortest recession in modern history, the current recovery is also quite spectacular, with US Durable Goods Orders (ex-Aerospace & Defence) at the highest level in 20 years.

In line with the above, the MMS, the global Montpensier proprietary Index of economic momentum is showing a strong recovery and sits at the highest in 3 years.

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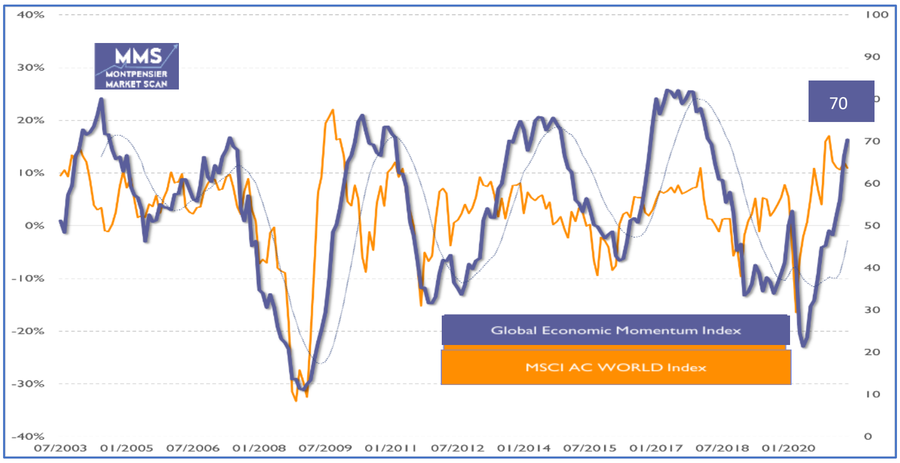
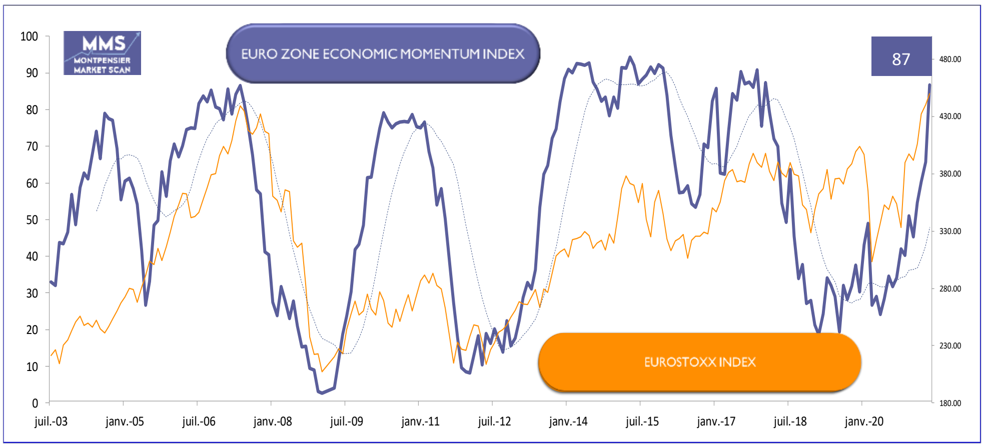


Source: Montpensier Finance / Bloomberg as of 28th May 2021

In Europe, after a late start, the vaccine roll-out is gaining momentum and the full re-opening is under way, pushing our MMS Index to an even higher level, close to a 10y high.

The growth momentum in Europe is even stronger



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The flip side of this strong recovery is a pick up in input prices.
Commodities have led the way : copper, iron zinc, lumber have all gone up a lot. And even if the oil price seems to be stable at around 65-70$ a barrel, it's hard to believe it traded sub zero in April last year.
Consumers and Production prices (CPI and PPI) have followed through and are now subject to upward pressure, albeit from a low base. Yet the German PPI is at 5.2%.
It's even more obvious in the US where PPI sits at 6% in April while CPI is at 4.2%.

Price pressure is also visible through wage inflation. Corporate America is raising wages en masse (Amazon, McDonald's or Chipotle to name a few) as they face labour shortage.

Not enough for the Fed and other Western Central banks to blink.
They are not thinking of thinking, leave alone talking of talking of tapering yet. Even if the last Fed Minutes mentioned the question of tapering, Fed officials have been quick at reassuring market participants and insisted on th CPI is at 4.2%eir view that they see any inflition as transient and the job market far from full employment.

Meanwhile, The Fed continues to buy $120bn of assets a month (it was 80bn at the peak of the GFC !), and its balance sheet continues to balloon.

The truth is that Central Banks are staying well clear of risking to kill the recovery as the ECB did in July 2011. By providing ample liquidity and easy financial conditions, central banks are also supporting the equity market, bolstering the wealth effect which is another way to support the economy.

But importantly, the Covid-19 crisis which brings along a lot of superlatives, has drawn governments into large support programmes for businesses and households and forced the West to extend deficits to record levels (15% budget deficit in the US, 10 in Europe).

We can see before our eyes a paradigm shift prompted by the pandemic and where governments are playing an increased rôle in the economy forcing central banks to remain extremely cautious when it comes to withdrawing any form of accomodation.
So far so good, unless inflation picks up in a way that can be seen as more permanent forcing central banks to be more hawkish or the market to anticipate an early tapering and prompting a tightening of the global liquity and financial conditions.

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