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# Did the Fed just kill the reflation trade?

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Predicting the future is hard, especially when it comes to the potential persistence of inflation and the appropriate monetary policy response in the latter stages of a global pandemic.

Inflation has been a hot topic of debate over the past few months. The combination of a low base for comparison, the re-opening of the economy and bottlenecks in global supply chains have led to US core inflation reaching 3.8% in May, the highest reading since 1992. A handful of sectors most directly affected by the pandemic have been the driver, including used vehicles, which were up 7.3% over the month, car rentals (up 12.1%) and airfares (up 7.0%). However, anecdotal evidence from company management across a range of sectors suggests that inflationary pressures are more broad based.

Until recently, the message from the Federal Reserve (the Fed) was that inflation was entirely transitory. While we have seen many commodity prices rise substantially and inflation breakevens in the bond market climb higher, investors have largely agreed with the Fed's assessment. In the latest Merrill Lynch Fund Manager Survey, 72% of respondents believed that the elevated inflation readings would indeed be transitory. A 30-year US treasury yield of 2.28% as at the end of May hardly suggested the market was concerned that inflation might be on the verge of heading out of control.

The term "reflation" gets used widely, but can be ambiguous as it refers to both real economic growth and inflation. Both have been important themes this year as expectations for each have increased substantially. Since the beginning of the year, consensus economic growth forecasts for the US increased from 3.9% to 6.6% and inflation ticked up from 2% to 3.5%. The vaccine rollout, the reopening of the economy and the substantial $1.9 trillion American Rescue Plan have proven to be a powerful mix for the economy.

The post Global Financial Crisis economy has been characterised by low growth and inflation, however the policy stimulus and recovery from the crisis has raised hopes that we could escape this uninspiring backdrop, often described as secular stagnation. Inflation is a politically charged topic often provoking strong views on both sides of the debate. Curiously, former Treasury Secretary Larry Summers, who was previously vocal on the risks of stagnation, has recently argued that the "primary risk to the US economy is overheating — and inflation".

The Fed's new Flexible Average Inflation Targeting framework has also caused some concern that they will fall behind the curve and allow the proverbial inflation genie out of the bottle. Summers continues that "the Fed's idea used to be that it removed the punchbowl before the party got good…now, the Fed's doctrine is that it will only remove the punchbowl after it sees some people staggering around drunk."



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The combination of this high-profile criticism, together with the extraordinary nature of the pandemic and the associated economic recovery, has provided a communications challenge for the Fed, particularly when it comes to unwinding the policy stimulus in the context of the new framework.

Markets saw some volatile moves after the Fed meeting in June suggested interest rates would rise earlier than previously expected. With 39% of Federal Open Market Committee (FOMC) members seeing a hike in 2022 and 61% seeing two hikes or more by the end of 2023 (72% see at least one hike in 2023), the market pricing reflecting Fed rate hike probabilities reset. The yield curve flattened, the dollar rose and many assets exposed to the reflation trade sold off.

Fundamentally, the market was reminded that inflation is still important to the Fed and interest rates are unlikely to remain at zero forever. There was also a technical aspect to the market moves as positioning in “reflationary” assets had become crowded. Such positioning can be akin to a lot of people on one side of a boat; a wave can throw people off balance and anyone leaning too far off the side runs the risk of going overboard.

Overall, monetary policy support will remain substantial as the Fed continues to buy $120 billion of bonds each month. Forecasts of future policy rates highlight where the ongoing debate is, and expectations for how this will evolve are dependent on how the future unfolds.

While inflation is likely to remain firm as we head into next year, the peak inflation fear has likely passed and the rate of economic growth peaking. Given the nature of the recovery from the pandemic it is inevitable that the rate of change will slow. The real question is whether the recovery continues through next year. With a US infrastructure package highly likely to pass later this year and the vaccine rollout supporting the reopening of Europe and emerging markets, the balance of probability suggests that this is a healthy mid-cycle pause for the reflation trade, and the focus will shift from inflation scare to the longevity of this growth cycle.

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