Week Ahead

Focus: EZ labor market, US Inflation

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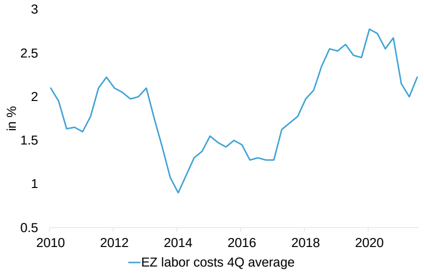
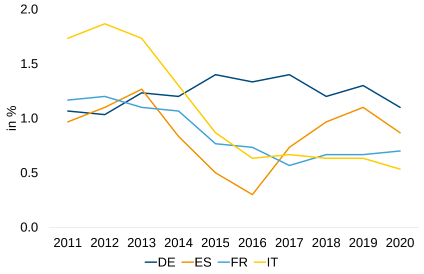
EZ labor costs (4Q average)



Source: Eurostat, Erste Group Reserach

Core inflation DE, FR, ES and IT (3 year average)



Source: Eurostat, Erste Group Reserach

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EZ - what does labor market recovery mean for inflation?

On the surface, the situation on the Eurozone labor market has eased further with the latest available data (November 2021). At 7.2%, the official unemployment rate has already fallen below the pre-crisis level. However, in our view, generous short-time work programs in some countries continue to help cushion the official unemployment rate. We estimate that, taking into account people on short-time working, the unemployment rate would still be around 10% at the end of 2021.

From a financial market perspective, the key question is at what point could the tightening labor market cause rising wage pressures. The pandemic has heavily distorted the data for labor costs and wages. But a four-quarter average shows that, by 3Q21, the downward trend in Eurozone wage growth should have come to an end. In line with the advancing economic recovery, we expect the unemployment rate to gradually decline in the coming quarters. This should lead to a further slight increase in Eurozone wages. The labor market data will therefore come back into sharper focus in 2022.

However, it is still unclear to what extent rising wage pressure could impact inflation. In the years before the pandemic, gradually rising wage pressures did not cause any visible upward pressure on Eurozone core inflation. In Germany, the core inflation rate remained largely stable, while in Italy and France it fell significantly until 2016, and has since stabilized at a very low level (around 0.6%). Only in Spain has core inflation risen visibly, in line with local labor market dynamics between 2015 and 2019. It now remains to be seen whether the substantial stimulus measures under the EU recovery plan can provide sustained upward pressure on core inflation in the coming years. To achieve this, the falling unemployment rate would have to lead to upward pressure on core inflation, especially in France and Italy.

We expect that a tightening labor market will only lead to subdued upward pressure on core inflation in the coming years. Following the historic rise in energy prices, we therefore forecast inflation to fall to 1.8% in 2023, from 2.9% in 2022.

Markets remain calm after further rise in US inflation

Although the US inflation rate published for December showed a further increase and reached the highest level since the early 1980s, bond markets reacted with lower yields and the dollar weakened. One reason was that the 7% y/y reading was in line with expectations, removing uncertainty from the market. Another reason was that price pressure essentially came from "known" price drivers. In the case of vehicle prices, the scarcity of semiconductors again had an impact. Prices of used vehicles rose by 3.5% compared to the previous month alone. Prices y/y are more than 37% higher. New vehicle prices rose more than 1% from the previous month and nearly 12% from a year earlier. Rents and the component estimating home prices showed elevated increases, as in previous months.

Perhaps also playing a role for the markets was the fact that December's reading probably represents the peak of US inflation for the time being. In the course of 2022, inflation rates are very likely to fall. There is widespread agreement on this in the market. However, there are major differences in the expected extent of the decline, which will be decisive for the central bank's further monetary policy and thus for the markets. The strong price increases of the previous year in some sectors will continuously drop out of the calculation and thus the inflation rate will fall. The question is whether new price pressure will build up elsewhere. We assume that the shifts in demand triggered by the pandemic will return to normal. For us, this also means that bottlenecks should dissipate and the catch-up effects that we suspect in rents should subside. While wage growth has accelerated in the US in recent months, this is partly due to sectors (leisure, transportation) that are particularly exposed to the pandemic shifts.

In recent months, there have been growing signs of rising inflationary pressures in the US. The Federal Reserve responded by tightening monetary policy more quickly. However, the further course of inflation remains highly uncertain due to the special situation in which the US economy will remain. Demand and the labor market remain distorted by the pandemic and its aftermath. This could worsen during the coming weeks or even months, as new COVID-19 infections in the US are many times higher than the old highs of a year ago. It should also be taken into account that even the higher wage growth is still below the rate of inflation, so that workers have to accept real losses in purchasing power, at least for the time being. In summary, the arguments in favor of a sharp decline in US inflation over the course of the year predominate for us.

Economic calendar

Ctry	Date	Time	Release	Period	Consens	Prior
Eurozone						
USA						
China						

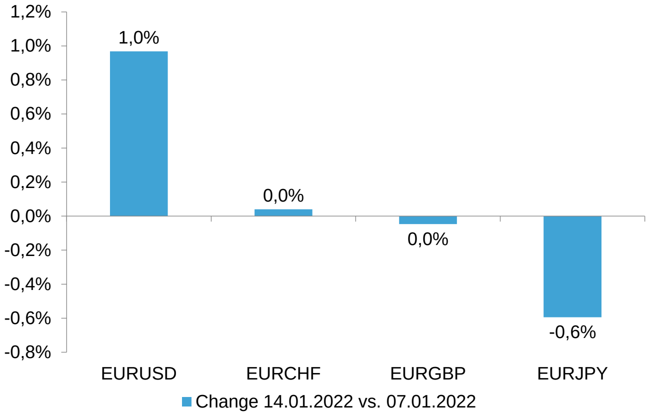
Central bank events

	Date	Time	Event
ECB	20-Jan	13:30	Account of the meeting of the Governing Council on 15 and 16 Dec. 2021
Fed			No relevant events

Source: Market Data Provider, ECB, Federal Reserve, Erste Group Research

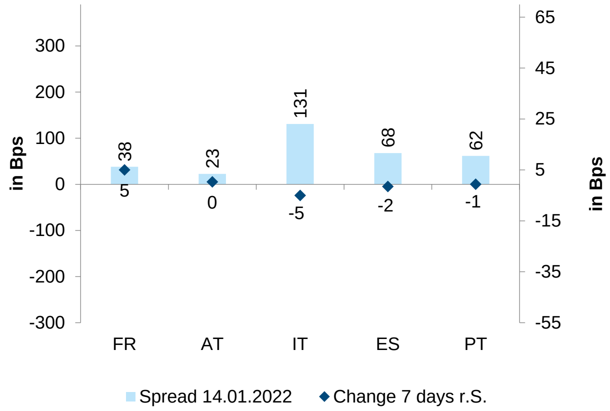
Forex and government bond markets

Exchange rates EUR: USD, CHF, GBP and JPY
Changes compared to last week



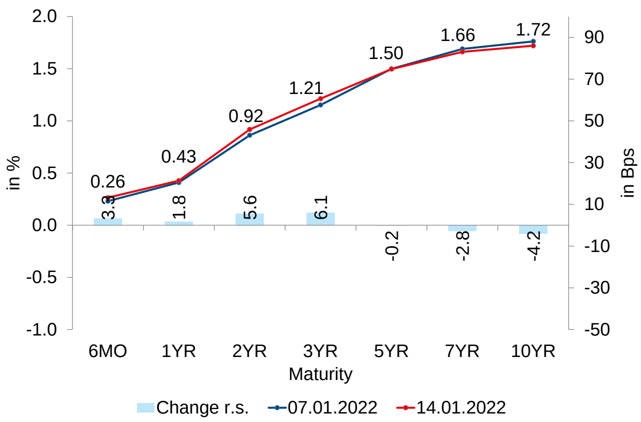
Source: Market Data Provider, Erste Group Research

Eurozone spreads vs. Germany
10Y government bonds



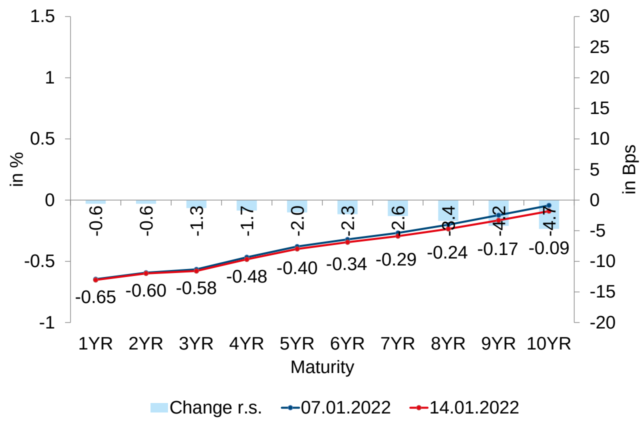
Source: Market Data Provider, Erste Group Research

US Treasuries yield curve
Changes compared to last week



Source: Market Data Provider, Erste Group Research

DE Bund yield curve
Changes compared to last week



Source: Market Data Provider, Erste Group Research

Forecasts[1]

GDP	2020	2021	2022	2023
Eurozone	-6.5	5.2	4.4	2.2
US	-3.5	5.7	3.3	2.3

Inflation	2020	2021	2022	2023
Eurozone	0.3	2.6	2.9	1.8
US	1.2	4.6	3.3	2.1

Interest rates	current	Mar.22	Jun.22	Sep.22	Dec.22
ECB MRR	0.00	0.00	0.00	0.00	0.00
3M Euribor	-0.56	-0.54	-0.54	-0.54	-0.54
Germany Govt. 10Y	-0.09	-0.10	0.00	0.10	0.20
Swap 10Y	0.33	0.20	0.30	0.40	0.50

Interest rates	current	Mar.22	Jun.22	Sep.22	Dec.22
Fed Funds Target Rate*	0.08	0.13	0.38	0.38	0.38
3M Libor	0.24	0.32	0.40	0.40	0.57
US Govt. 10Y	1.72	1.60	1.80	1.80	2.00
EURUSD	1.15	1.15	1.15	1.15	1.15

*Mid of target range

In case of changes to our forecasts compared to the previous issue, arrows show the direction of the change.
Source: Market Data Provider, Erste Group Research

[1] Note: In accordance with regulations, we are obliged to issue the following statement: Forecasts are not a reliable indicator of future performance.

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