

INFLATION: “SHADOW BASE EFFECTS”!

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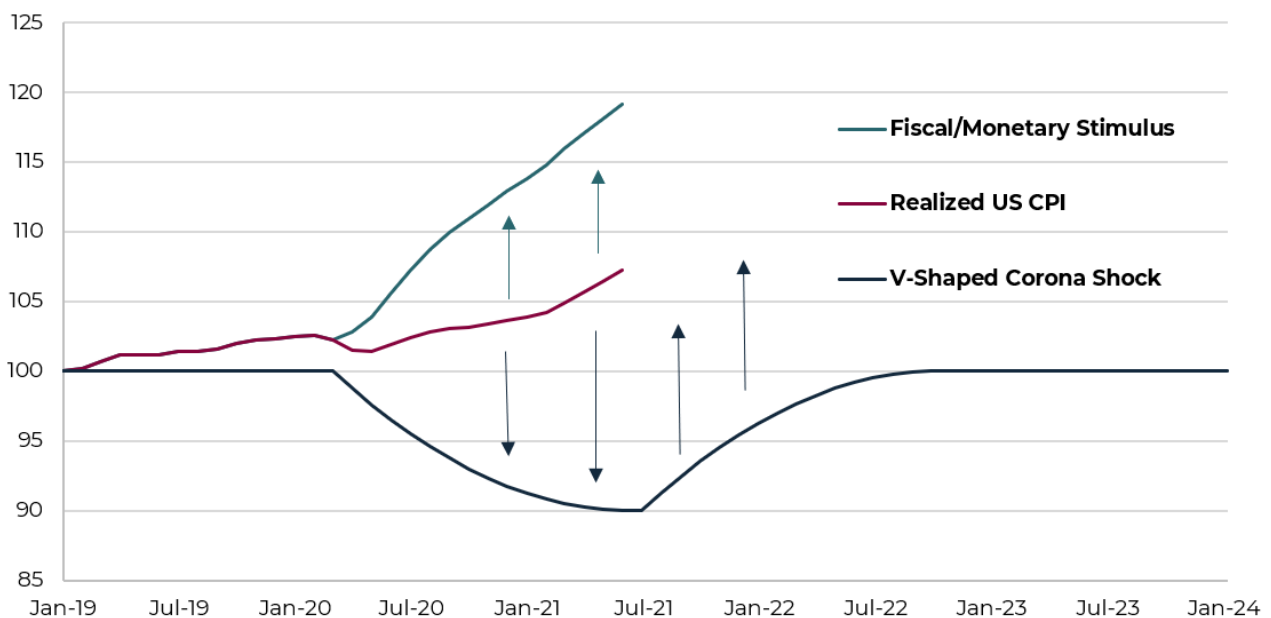
INVESTMENT FIRM

POWELL MIGHT BE MISSING THE POINT: “SHADOW BASE EFFECTS”!

On June 16, Jay Powell is going to talk a lot about base effects. While those are important, he might be missing the point that the US CPI impact arising from the corona shock could be lagging. As Bank of England has stated: “We reaffirm Friedman’s result that it takes over a year before monetary policy actions have their peak effect on inflation”. Imagine that the same goes for the “V-Shaped Corona Shock” last year, but that these initially deflationary pressures have been more than outweighed by the combined fiscal and monetary stimulus.

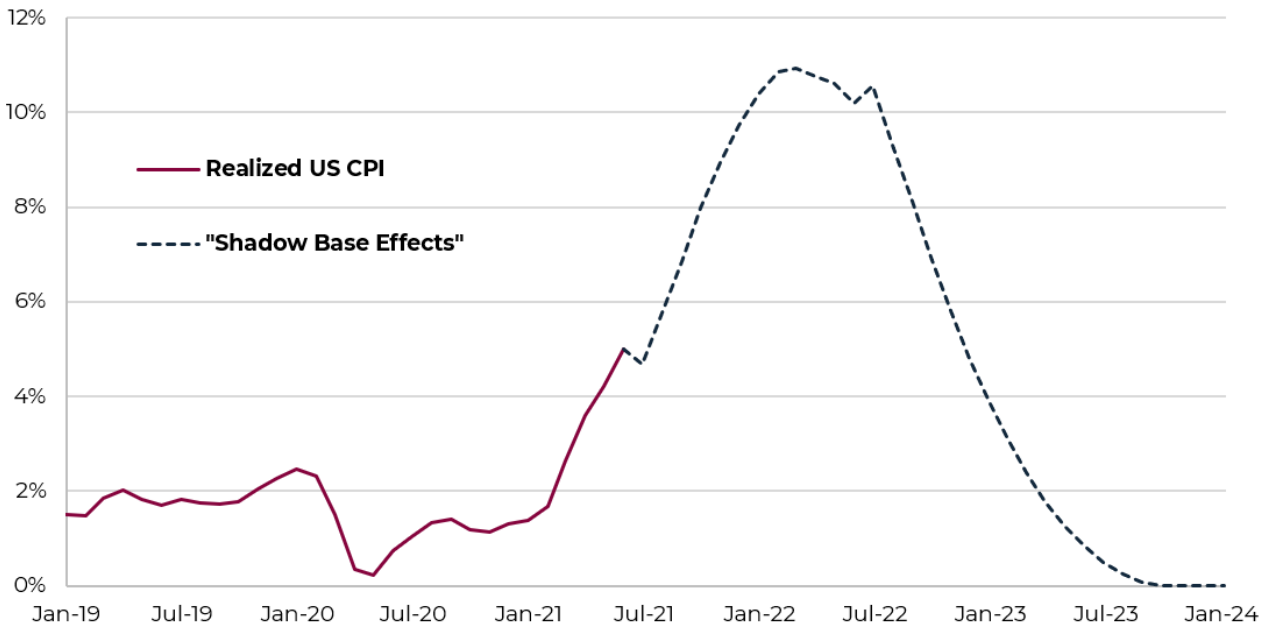
If this is the case, the deflationary pressure will only now begin to wear off and instead be reversed by the inflationary pressure arising from the right-hand-side of the “V”. Whether this is the case or not is of course an open question, but in CABA Capital we believe that there is a good probability that it is. We have illustrated this phenomenon - which we have coined “Shadow Base Effects” - in the chart below (based on our best guesstimates).

Guesstimated Decomposition of US CPI



If this phenomenon turns out to be real, and if we move forward in time with an unchanged level of fiscal and monetary stimulus (even though this effect is probably also lagging, pulling in the same inflationary direction), these “Shadow Base Effects” have the potential to significantly boost US CPI in the years ahead. This is, all else equal, illustrated on the following page.

Potential US CPI impact from "Shadow Base



Only time will tell what happens next, but we believe that the coming years will continue to show US CPI surprises to the upside and that "Shadow Base Effects" will be playing an essential role. Therefore, we think Powell should be more focused on this phenomenon and start adding a "Shadow" to the ordinary base effects that he relies so heavily upon.



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