Insight INVESTMENT

INFLATION OUTLOOK
FOCUS: GLOBAL INFLATION

AUGUST 2018

> Should investors be worried about global inflation? We examine the short and long-term factors currently impacting inflation data.

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SUMMARY

- Inflation has accelerated globally as growth has strengthened, buoyed by an upturn in commodity prices
- This has led to an increase in inflation forecasts for 2018 and 2019
- For now, we believe that this is merely inflation returning to levels more consistent with this stage of the economic cycle
- We would highlight four key factors which could act to contain inflationary pressures in the short term
- Longer term, we anticipate low levels of spare capacity increasing the risk of policy error in a world where the long-term effects of unconventional monetary policy are still unknown

INFLATION OUTLOOK
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INFLATION HAS ACCELERATED GLOBALLY AS GROWTH HAS STRENGTHENED, AND INFLATION FORECASTS FOR 2018 AND 2019 HAVE SHIFTED UPWARDS. WE EXAMINE THIS SHIFT IN A HISTORICAL CONTEXT AND HOW THE OUTLOOK HAS EVOLVED BOTH ON A SHORT AND LONG-TERM BASIS.

INFLATION, RETURNING TO CYCLICAL NORMS

In 2017 the global economy enjoyed a synchronized upswing, with growth accelerating across both the developed and developing world. Unemployment declined and inflationary pressures, unsurprisingly, started to rise. This marked a turning point for major central banks, increasing their confidence that the post-financial crisis era of extraordinarily loose monetary policy was drawing to a close. Although forecasts for inflation in both 2018 and 2019 have increased (see Figure 1), we would not regard this as overly concerning, but merely as a shift back to levels more consistent with this late stage of the economic cycle. Compared with the average over the last 20 years, global inflation is actually expected to be slightly below average in 2018 and 2019, despite slightly above-average levels of growth.

In 2018, inflation is expected to be dispersed amongst major economies, undershooting central bank targets in Japan and the eurozone but overshooting in the US and UK (see Figure 2). This in part explains the faster pace of monetary policy normalization in the latter countries. In 2019, however, inflation is expected to converge on-target across the developed world.

In the short term, there are a number of reasons why markets expect the pace of inflation to be contained. But underlying inflationary pressures are gradually building as global labor markets tighten and the level of spare capacity in the global economy declines. The result is persistent pressure on major central banks to normalize policy, albeit at a gradual pace.

Figure 1: Global inflation versus global growth[1]

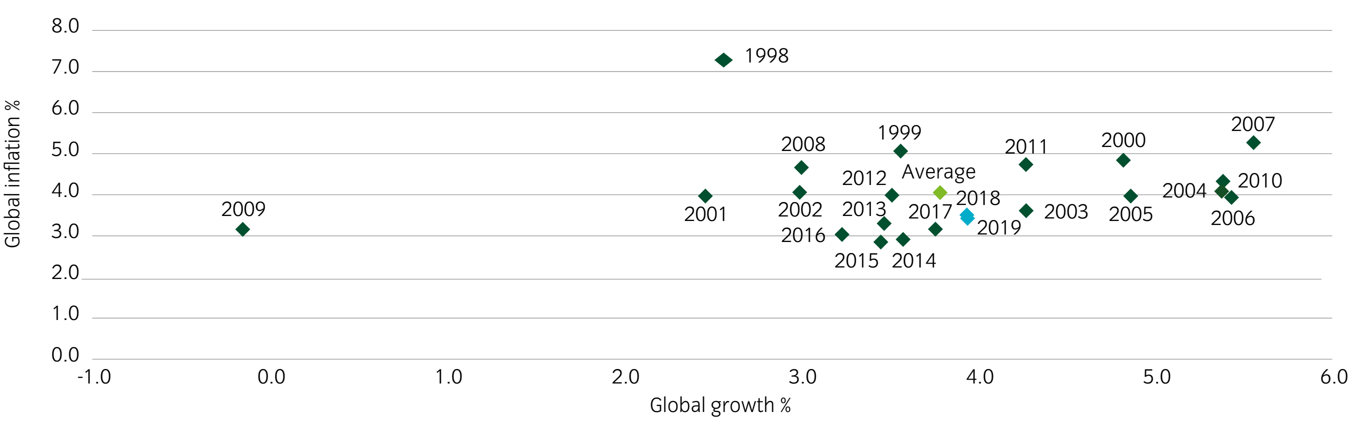
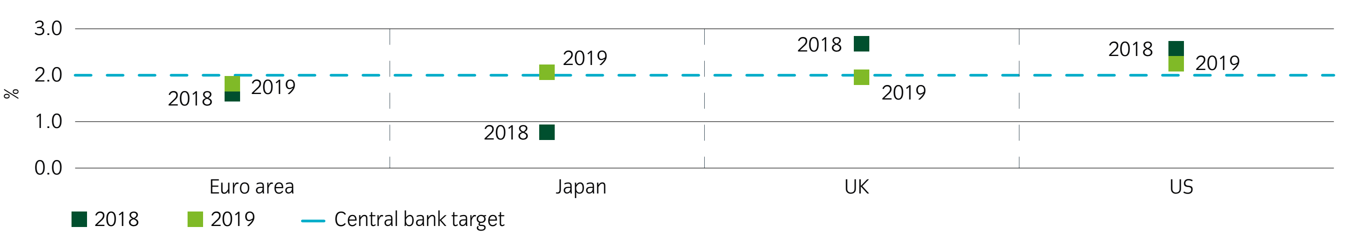


Figure 2: Inflation forecasts versus central bank targets[2]



[1] Source: IMF. Data as of June 21, 2018, 2018 and 2019 data is a forecast. [2] Source: IMF. Forecasts as of end April 2018. Forecasts are estimates based on data that is currently available. As such, they are not a reliable indicator of future performance.

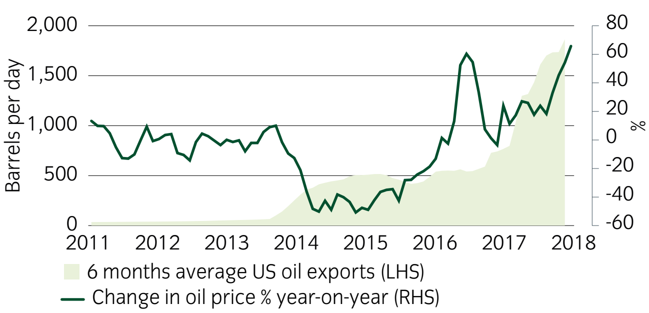
WHY INFLATIONARY PRESSURES SHOULD REMAIN CAPPED FOR NOW

The uplift from global oil prices is unlikely to be sustained

Global oil prices have recovered strongly following the joint accord between OPEC and a number of non-OPEC countries which was struck in late 2016. More recently, falling production in crisis-hit Venezuela and the reintroduction of sanctions on Iran have acted to further support global oil prices. Oil prices have both a direct impact on headline inflation, but also second-round effects as they increase input and transportation costs for a broad range of other goods and services.

Although the recent price increase will put upward pressure on global inflation in the short term, there are a number of reasons to be believe that further significant gains are unlikely and in fact prices may start to moderate. Firstly US shale oil production continues to grow, with most operations highly profitable at current oil prices and US oil exports are growing rapidly (see Figure 3). Secondly, OPEC at its latest meeting agreed an effective 1m barrel per day increase in production, which should allow inventories to rebuild.

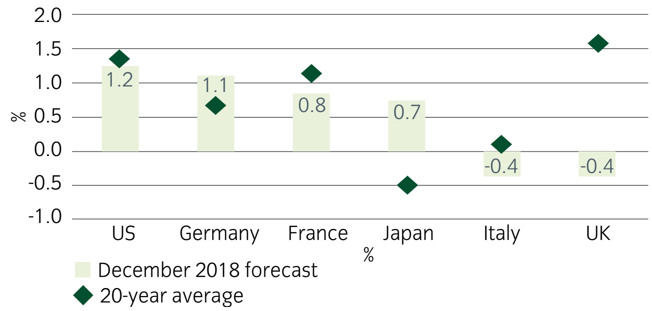
Figure 3: Brent oil price change (% Y/Y) versus US oil exports[3]



Wages continue to face headwinds

Although developed market unemployment is close to a 40-year low, wage pressures have, so far, remained subdued. Real wages in most countries are still growing at levels well below historical averages (see Figure 4). In 2018, the OECD expects only Germany and Japan to have real wage growth higher than the long-term average, with Japan the result of a government campaign to promote salary increases following years of decline. In the UK, the OECD expects real wage growth to be negative in 2018, but this forecast now looks out of date given recent data. Even if revised upwards, however, it will still be far from long-term average levels.

Figure 4: Forecast 2018 real wages (using core inflation) versus 20-year average[4]



There appear to be various reasons for this lack of wage pressure. In the US and Japan, headline unemployment rates mask a decline in the level of labor market participation. Although part of this is due to demographics, with the baby-boomer generation reaching retirement, as labor markets have tightened, so some of these workers are starting to re-enter the labor market. There is thus a larger pool of potentially unused labor than headline unemployment data suggests. In Japan, this is exacerbated by historically very low participation amongst the female population who are now rapidly moving into work. Other trends include an evolution in the way people are employed. In the UK for example the number of self-employed workers has risen rapidly, with people choosing flexibility and new models of working, such as driving for Uber, over traditional roles. These trends should continue to keep wages capped in the short term.

China should remain a disinflationary force

Monetary conditions have been tightening in China since late 2016. Chinese authorities have been gradually broadening and increasing their reach to bring lending and financial activities conducted by unregulated institutions (known as shadow banking) into the regulated banking sector. In November 2017, China announced the establishment of the Financial Stability and Development Committee, which was a new regulatory body with sweeping powers designed to stop financial institutions from circumventing rules. This was followed in April 2018 with a significant new set of rules to better regulate the asset management industry, preventing the use of wealth management products to evade banking regulations by lending directly to higher risk corporations.

[3] Source: US Department of Energy and Bloomberg, data as of end June 2018. [4] Source: OECD. Data is a forecast.

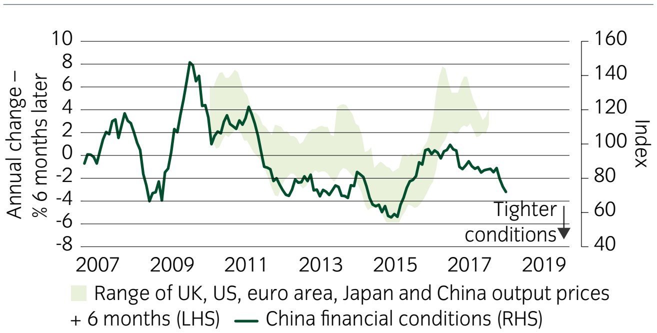
> I expect that, with appropriate monetary policy, the job market will remain strong and inflation will stay near 2 percent over the next several years.

FEDERAL RESERVE CHAIRMAN JEROME H. POWELL

Tighter monetary conditions have acted to rein in Chinese inflation, with forecasts that it will remain below the central bank's 3% target through 2020. Declining food prices, a significant component of Chinese CPI, mean that the risk is that current inflation forecasts are, if anything, too high. A reduction in tariffs on key food imports such as pork products on July 1, 2018 will compound this.

Historically, Chinese monetary conditions have had a high correlation with developed market output prices (see Figure 5), as developed market companies have become increasingly reliant on imported Chinese components for their own manufacturing processes. When inflation and producer prices in China are contained, they effectively export disinflation to the developed world.

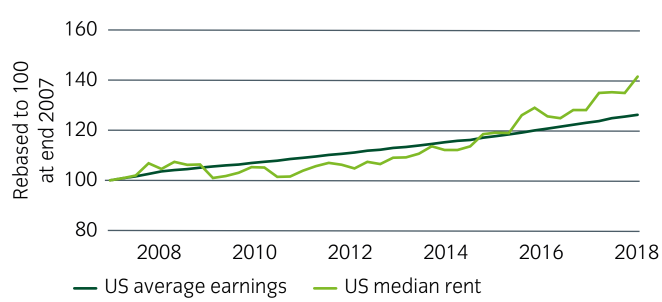
Figure 5: Developed market producer output prices and Chinese financial conditions[5]



The inflationary tailwind from US owners[1] equivalent rent may be coming towards an end

Owners' equivalent rent is the price that a homeowner would theoretically pay to rent their primary residence and is a significant proportion of US inflation. Rising rental values have been pushing US inflation upwards over recent years, but a number of factors would suggest that this effect could start to dissipate. Rents have outpaced earnings (see Figure 6) and this is making home ownership more attractive, even for a population scarred by memories of property price declines during the financial crisis. Vacancy rates for rental units declined over a number of years, but have stabilized over the last 12 months, while at the same time homeownership levels have started to move upwards and building levels are accelerating. The extended level of rents relative to earnings should start to act to contain future gains.

Figure 6: US average earnings versus rents, rebased 2007[6]



[5] Source: Insight Investment and Bloomberg, data as of end June 2018. [6] Source: Bloomberg. Data as of end March 2018.

BUT THE SHORT TERM IS NOT WITHOUT RISKS

Brinkmanship before a global trade war?

Although in the short term some factors which have pushed inflation higher may start to become less important, the political backdrop certainly presents some risks. Tensions around international trade have escalated in 2018 as US President Donald Trump has pressed ahead with plans to impose tariffs on US imports. So far, the US administration has announced a package of tariffs on $50bn of Chinese imports which will be implemented in two tranches. The first tranche will focus on $34bn of products taken from a list published in April and with a planned start date of July 6. A second list is then to be drawn up for the remaining $16bn of products following a further review and public hearings. The tariffs will largely be aimed at those sectors that are part of China's 'Made in China 2025' plan, which is strategically designed to move the Chinese manufacturing industry up the value chain, with a goal of domestically producing 70% of core materials by 2025. President Trump has also threatened a 10% tariff on an additional $200bn of goods.

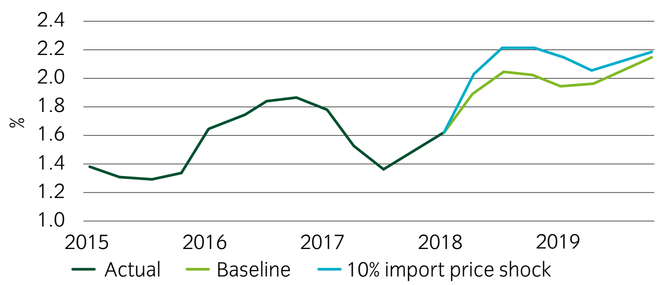
In a broader measure, a 25% tariff has also been imposed on imports of steel and aluminum. Initially, a number of countries deemed to be 'key allies' of the US were exempt from these tariffs, but that exemption expired on June 1.

Retaliatory measures have started

Retaliatory measures have started; China has released an updated list of 500 categories of US goods which it will impose retaliatory tariffs on, aimed at products produced in Republican-voting states. In response to steel and aluminum tariffs, the European Union (EU), Canada and Mexico imposed counter-tariffs which in aggregate will affect $18.6bn of US exports.

Ultimately, if there was a full-blown global trade war it would certainly have an impact on global inflation, pushing prices upwards. But it would also likely have a negative impact on global growth, counterbalancing the inflationary impact to some extent. The shock would also be transitory. In Figure 7 below, Bank of America Merrill Lynch models the expected impact of a 10% average tariff increase on US core inflation which highlights the transitory, although significant, impact.

Figure 7: US inflation scenario[7]

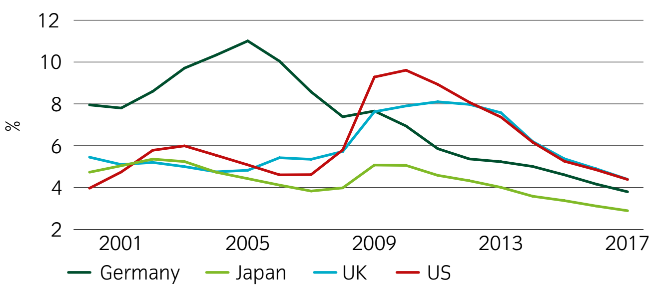


[7] Source: BofA Merrill Lynch Global Research as of July 2018.

LONGER-TERM PRESSURES ARE BUILDING

The longer-term inflation outlook is deteriorating and is likely to continue to deteriorate unless something occurs to cause the global economy to meaningfully lose momentum. The synchronized upswing in growth experienced in 2017 eroded the level of unused capacity in major economies. Although, as previously discussed, there are some trends which are bringing people back into labor markets, unemployment has dropped significantly and companies are operating with historically low levels of spare capacity. These factors are yet to coalesce into a more concerning inflationary trend, but there is now little spare capacity available to facilitate any further period of above-trend growth.

Figure 8: Unemployment rates in key markets[8]

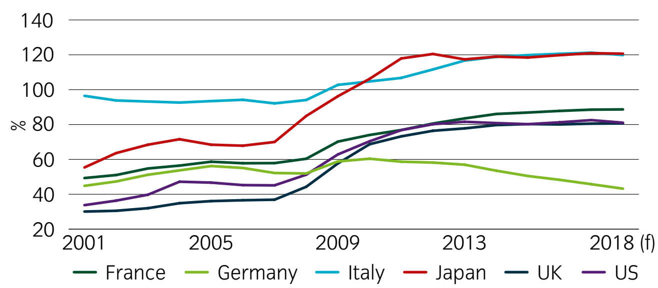


This deterioration follows an extended period of ultra-low interest rates, with major central banks pursuing unconventional monetary policy, the long-term consequences of which are still unknown. Fears surrounding the fragility of the economic recovery, combined with a lack of inflationary pressure, have made major central banks wary of normalizing policy too quickly and interest rates remain low relative to where they would normally be at this stage in the economic cycle. For example, a recent study by JP Morgan used the Taylor rule[9] to estimate where interest rates should be at the end of 2019 in order to be consistent with the stated inflation objective of each of the major central banks. This study concluded that an appropriate policy rate would be 4.4% in the US, 2.6% in the eurozone and 1.3% in Japan, well above current market expectations.

WHAT HAPPENS IF THERE IS AN INFLATION SURPRISE?

In the event of an inflation surprise, a shift towards more rapidly tightening monetary policy is not without consequences. Debt levels globally have increased as a result of ultra-low policy rates and this increases the pressure for central banks to act in a manner which is gradual and fully transparent. In most major countries, net government debt has significantly increased following the global financial crisis, with only Germany reducing its net debt to GDP. Corporate and personal debt has also increased, as ultra-low interest rates have caused borrowing to rise.

Figure 9: Debt to GDP (%), major economies[10]



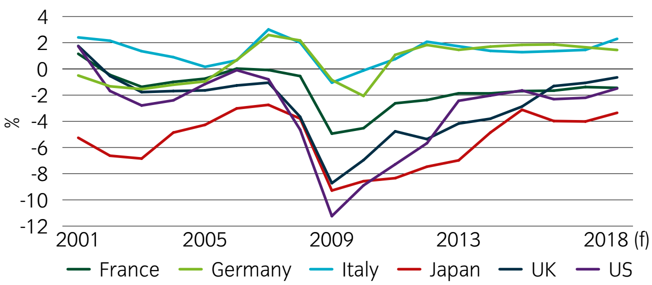
This leaves major central banks faced with a constant battle to manage market expectations, as they seek to prevent any disorderly upward move in longer-term bond yields. If inflation were to start to surprise on the upside, it would test the limits of market confidence in these policies and could result in unforeseen consequences.

[8] Source: IMF, data as of end December 2017. [9] The Taylor rule is an interest rate forecasting model invented by John Taylor in 1992.
[10] Source: IMF, data as at end April 2018.

Unconventional policy could become conventional

Although budget deficits have improved from their post-crisis levels (see Figure 10), fiscal easing in the US and Italy could now lead to higher budget deficits in those countries. This means that, in the event of any future economic downturn, the potential for further fiscal expansion will likely be limited. As a result, unconventional monetary policy measures could well become a more regular part of central bank toolkits over time.

Figure 10: Budget deficits (% of GDP), major economies[11]



The political changes that have taken place in the US and Italy are also just part of a dramatic shift towards what some in the media are classifying as 'populism'. Possibly driven by the unusually low level of wage growth since the financial crisis, traditional mainstream political parties are being swept aside by new parties and leaders, often with little political experience. These populist parties tend to have simple policies which have mass appeal, regardless of the longer-term economic consequences. The effectiveness of quantitative easing in capping bond yields has led to the idea that it could be used for the purposes of funding future government spending. For example, in the UK, Labour Party leader Jeremy Corbyn proposed such a policy - dubbed "People's Quantitative Easing" - in the 2015 leadership election for the Labour Party, suggesting such an approach might be put into practice at some point in the future.

CONCLUSION

Inflationary pressures have picked up globally, but have merely returned to cyclically normal levels. In the short term a number of forces which have pushed inflation higher in the UK and US may be starting to run out of steam, which is one reason why inflation is forecast to fall back towards central bank targets in 2019. This, however, conceals a fundamental change in the global economy, with little spare capacity available to facilitate a more extended period of above-trend growth. Underlying inflationary pressures are building, but developed market central banks continue to be cautious. This stems in part from years of unconventional monetary policy, leaving policymakers fearful of any action which could be perceived as damaging the growth outlook. But it is also a result of an increase in leverage, after debt increased to take advantage of historically low interest rates, which has amplified the effect of policy changes.

A full-blown trade war is a risk to the short-term outlook, with broad-based tariffs having the potential to push inflation higher across the world, at least in the near future. If trade tensions ease, and global growth continues unchecked, a lack of spare capacity increases the risk that inflation will start to move upwards over time. Wage growth has been subdued, even though labor markets have tightened, in part due to growing levels of participation amongst older and female workers and a shift towards less traditional labor models. This trend is still in place, but at some stage labor shortages are likely to become more pronounced.

A shift towards political populism creates further uncertainty, while ageing populations and perceived inequality raises the risk that unconventional monetary policy may become a method to achieve political goals regardless of consequence. This could occur before we discover the full consequences of policy measures enacted over the last decade.

[11] Source: IMF, data as of end April 2018.

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