Market Voice

Answers, advanced.

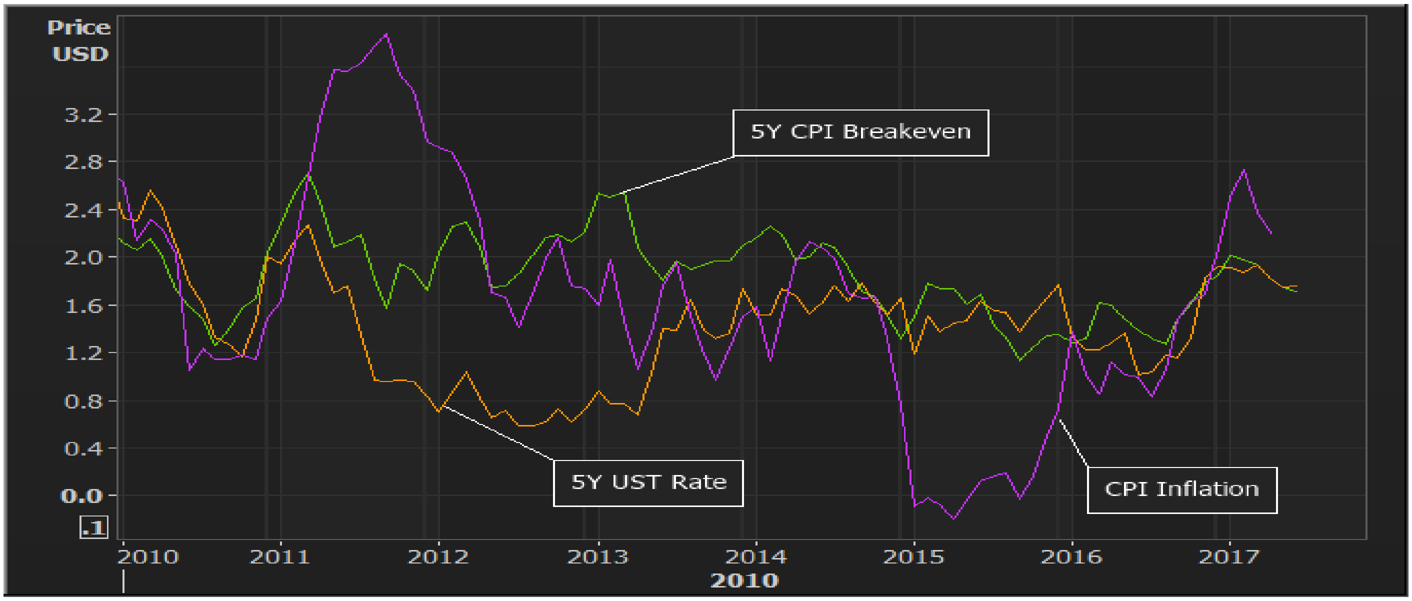
June 2017

On the Cusp of More Inflationary Times?

The US unemployment rate dropped to 4.3% in May, a level not seen since the height of the dot-com bubble almost twenty years ago. Conventional economic thought, characterized by the “Philips Curve”, posits a fundamental trade-off between unemployment and inflation. Low unemployment should put upward pressure on wages and production costs leading to higher inflation.

It is tempting to say “this time is different” and the market seems to be drifting into this mode. As shown below, CPI inflation has trended higher since 2015 and began 2017 at a 5-year high. Inflation has since moderated – largely reflecting softer oil prices – but remains well above levels seen in recent years. 5-year breakeven inflation (the inflation rate equalizing the return on standard and CPI-adjusted Treasury bonds) while firmer, is well below actual inflation, and remains in the range of recent years; the same is true for the yield on 5-year Treasury bonds. The bond market is priced for inflation to reverse and, despite the decline in unemployment, move back into the prior 1.5-2.0% range for the next five years – not shown, but also out to ten years – and this has implications for the stock market. SPX price/earnings are an expensive extreme in outright terms; but while high, they are within the normal range when adjusted for bond yields (see the April Market Voice). Maintaining the lofty SPX pricing requires the new normal of sustained low inflation and yields in the face of historically low unemployment. But thoughts of a new normal can be dangerous as it was this type of thinking that allowed the US real estate crisis to emerge and, indeed, the dot-com bubble as well.

United States CPI Inflation, 5-Year Yields and “Breakeven” Inflation Rate



Source: Thomson Reuters Eikon

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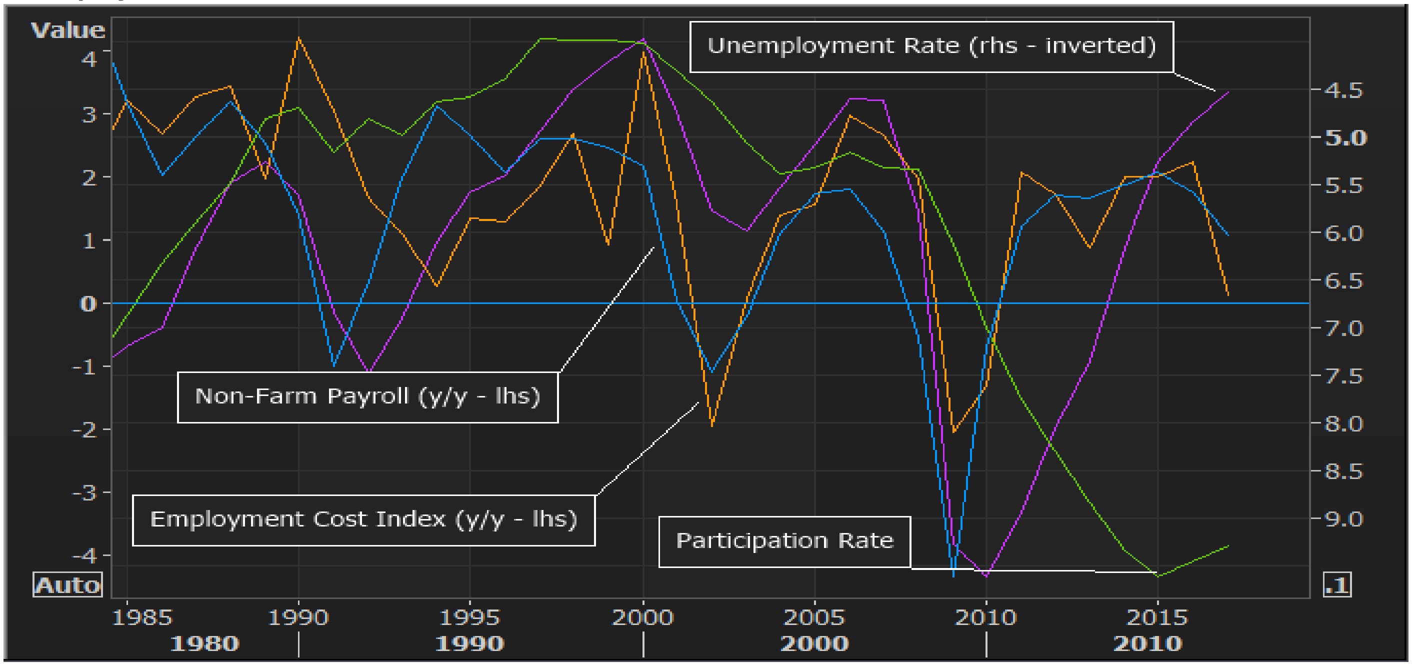
Unemployment, Job Growth and Labor Costs



Source: Thomson Reuters Eikon

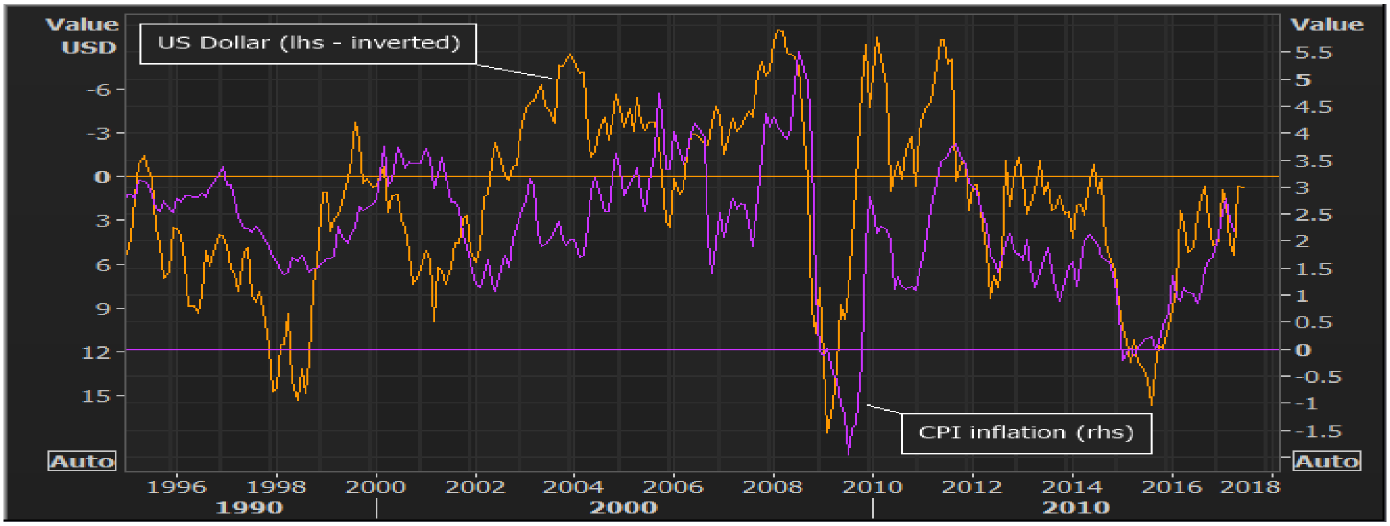
It Does Not Matter Whether the Chicken or Egg Came First – It's All About the Feedback Loop

Like the chicken and egg conundrum, it is hard to figure whether wage gains breed inflation or inflation allows wages to rise. But regardless of which comes first, the feedback between inflation to wage gains back to more inflation – or vice versa – is the backbone of an inflationary cycle. As low unemployment is indicative of a tight labor market, it should be reflective in upward pressure on wage rates abetting the onset of an inflationary cycle. Consistent with this, as is apparent above, growth in unit labor costs generally tracks the unemployment rate but an aberration is now appearing; wage growth has stalled over the past two years even as the unemployment rate plunged to new lows.

The divergence may be a byproduct of a decline in the participation rate – the percent of the working age population that is working or seeking employment –is at its lowest level since the 1970s. The decline in the unemployment rate has reflected a decline in the workforce as well as gains in numbers employed. Normally, the participation rate shadows unemployment since a better job market encourages people to re-enter the work force so the current divergence between unemployment and participation is unusual. But in this specific realm there is truly a new normal; the bulge of baby-boomers hitting retirement age creates an unusually high proportion of the population that is no longer in the workforce. In addition, there is some evidence that substantial numbers of people left behind by technological change and unwilling to work at the available low wage jobs have also dropped out of the workforce. Participation rate and by inference the unemployment rate has now become a problematic indicator of inflationary pressure as the changing landscape makes it difficult to assess under what circumstances people will move off the sidelines.

So there is a case to be made that there is a new normal upsetting the traditional link between low unemployment and higher inflation. Fortunately there is still a viable alternative to track inflationary pressures. Payroll gains remain a robust relation with inflation still providing a barometer to employment conditions and pressure on wages. Indeed, while a bit exaggerated, the slowdown in wage growth is consistent with a slowing in job growth that occurred in the early months of 2017. **Annual payroll gains of at least 2% are required to create the kind of wage gains that underpinned the upward trend in inflation over the past few years**. So for the time being, the bond market – and, by inference equities – are reasonably priced given the recent slowdown in job growth. But there is a risk that if the Trump Administration implements a strong stimulus package that the old normal could re-emerge with a vengeance.

Dollar Depreciation and US Inflation



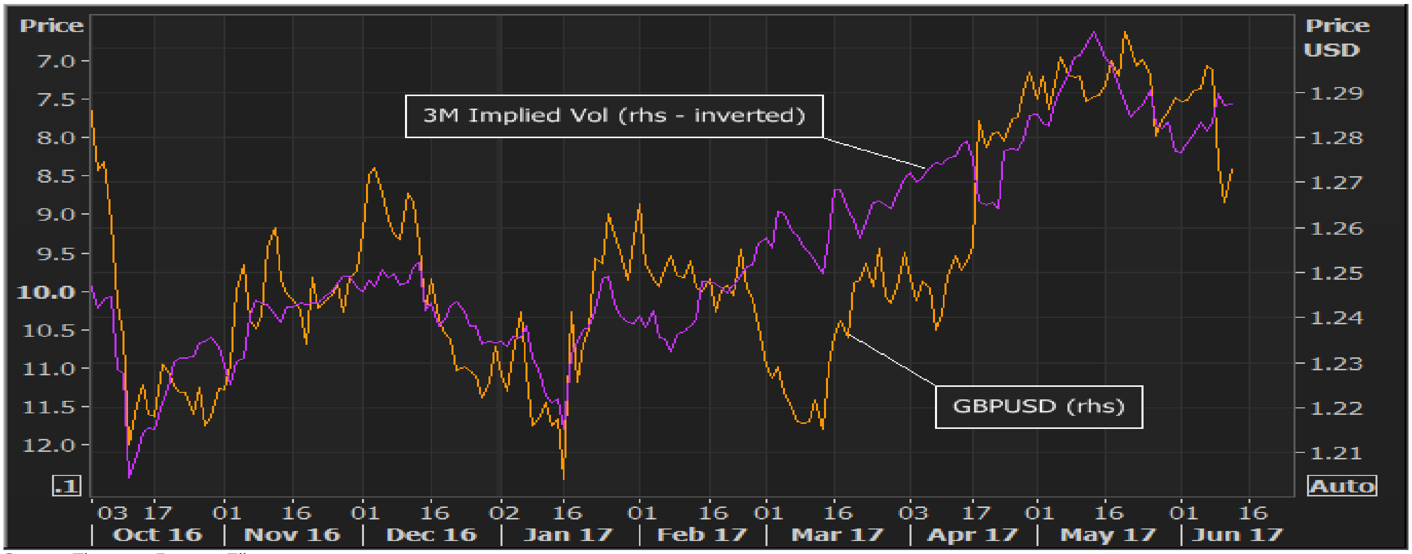
Source: Thomson Reuters Eikon

The Dollar May Pose an Emerging Source of Inflation Risk

As shown above, until recent years there was, at best, a marginal link between USD strength and inflation. This may explain why the dollar's value has rarely been a policy priority for either the Fed or US Treasury. In the years since the financial crisis, however, a fairly strong and persistent link between dollar performance and inflation has emerged. There are a variety of reasons why the dollar may have gained in importance as a driver of inflation and not least that imports are now roughly 15% of GDP compared with 5% in the early 1960's. Increasingly integrated global supply chains may have accelerated the feedthrough of dollar movement to domestic prices. Indeed, the globalization of the US market may explain a conundrum in the stagnation of US wages. There is anecdotal evidence that US businesses are often foregoing opportunity to increase output in response to strong demand if hiring additional workers requires hiking wages potentially forcing an increase in prices. It may be that the threat of a growing universe of global competitors is making producers reluctant to be compelled to raise prices. In any event, it appears that even a modest weakening dollar trend – e.g., 1-2% annually – would be consistent with inflation moving well above a 2% trend rate.

In the absence of the Trump Administration implementing a budget with a substantial fiscal deficit which is growing politically less likely, the US economy probably cannot produce the 2% plus employment growth required for an emergence of significant inflation. But the dollar does pose a more imminent risk as the emergence of even a modest depreciating trend could generate levels of inflation that would force a substantial repricing of the bond market and by inference equity markets as well. **The real new normal is that the dollar and not the employment market is what to monitor for risks of inflation and a repricing of bond rates.**

GBPUSD Spot and 3M Implied Volatility

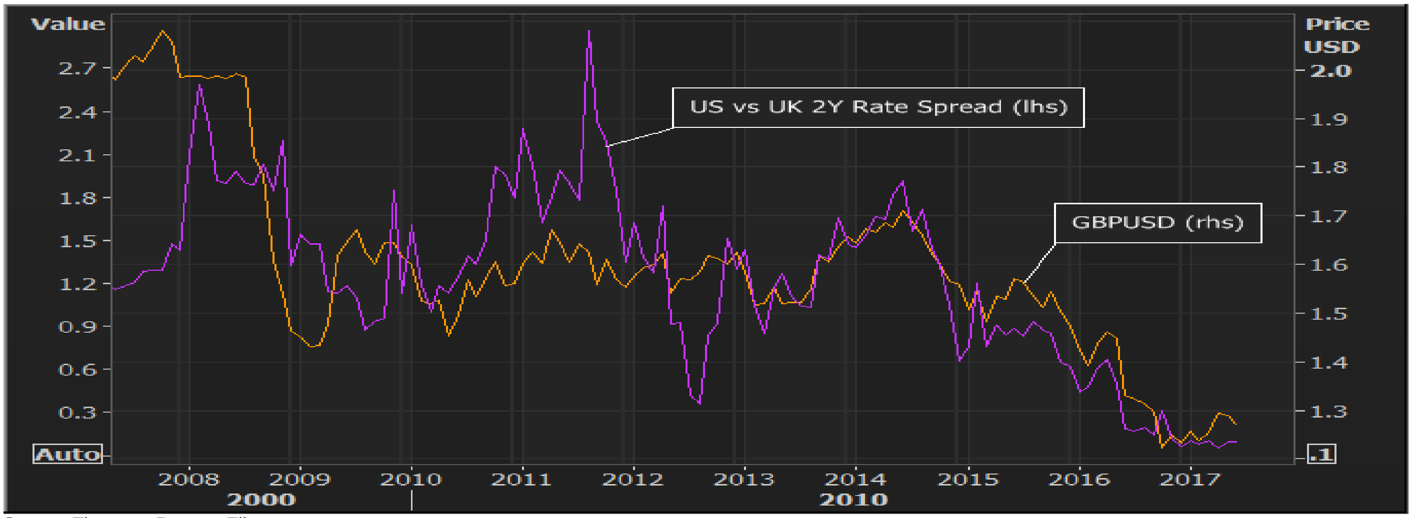


Source: Thomson Reuters Eikon

No Exit for Brexit

Once again a UK vote did not play out as expected with the Conservative party's stunning reversal in the Parliamentary vote. The Conservative party is now forced to form a coalition with the Democratic Union Party (based in North Ireland) in order to have a working majority in Parliament. The history of UK coalition governments does suggest the prospects for longevity are not good so there is a good chance new elections will be required in short order. In the meantime, Prime Minister May's ability to negotiate Brexit with the EU has been compromised and she is likely to face continued pressure to resign her from her party. All-in-all, this suggests a very uncertain outlook for the path to Brexit and prospects for GBP. No surprise that GBP weakened in the wake of the election outcome, as shown above, hitting a two-month low. But even with the very cloudy future, GBP implied volatility hardly budged remaining near its lows of the year. Moreover, even in the absence of any direct Brexit affect, the chart below indicates that GBP is biased to weakness given the spread of UK vs US 2-year government bond rates. It looks like GBP is headed lower and that puts are attractively priced.

GBPUSD Spot UK vs. US 2-Year Rate Spread



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