From reflation to inflation: the return of an old enemy

\- Reflation is here to stay, eventually opening the door to inflation
\- The stars are aligned for growth to make a longer-lasting appearance around the world
\- Given this backdrop, we favour inflation-linked bonds and equities over credit and government bonds

For 2017, we expect higher inflation and higher growth than the consensus.

Our “nowcaster” indicators – a real-time synthetic measure of growth and inflation surprises – show increase, and our analysis suggests this trend will continue.

These themes are the main drivers of our dynamic investment view.

For us, the clear call is to be overweight inflation-related assets. Inflation-linked bonds and commodities are our favoured assets, while we expect nominal bonds to suffer.

Our calculations of current fair value based on potential GDP and inflation come out at 2.80% for the US 10-year Treasury and 0.4% for the 10-year Bund. If we add Federal Reserve and ECB forecasts, fundamental fair value is significantly above current levels.

We are therefore overweight inflation break-evens and commodities (industrial and energy) and underweight sovereigns, particularly in Europe, where they are furthest from fair value because of low inflation pricing and the scarcity of short-dated paper.

We are also long growth assets, while acknowledging political risk. Our preference is for developed and emerging equities at the expense of credit.

Much of the increase in equity valuations in the aftermath of the US elections has come from multiple expansion. Something similar was seen after Brexit.

This “buy the rumour, sell the news” pattern could repeat in 2017 and we may need to add some cost-effective foreign exchange or defensive value hedges to our equity positions along the road to year-end.

Unigestion’s World Growth and Inflation nowcasters

Source: Unigestion
What’s driving higher prices?

The economy’s shift from deflation to reflation and on to inflation is driven by three factors: commodities, overcapacity in the global economy, and global costs.

Inflation is on its way: deflation expectations retreated during the past six months and a reflation theme appeared in markets in the aftermath of the Brexit vote. Whereas inflation can be defined as a period of consumer price growth above its long-term average, reflation is a period of price levels recovering from low levels to this long-term level. Such an episode occurred in 2016 across the developed world. Oil prices played a significant role, both in terms of the deflation theme that was in force up to February 2016, and the reflation theme prevalent since then.

Oil price weakness – one of the most significant macro risks of the 2015-2016 period – is no longer a concern. Oil inventories are declining and, more importantly, oil demand has increased significantly since March last year. The improvement in emerging markets has probably been one of the major factors behind this recovery, and supply and demand dynamics are consistent with a stabilisation of the oil market, which should support inflation dynamics worldwide.

The second factor in the inflation equation is global wage growth, which shows signs of getting stronger after remaining muted for the past four years. The “wage growth” component of our inflation nowcaster depicts a world where wage growth remains around its long-term average, which is neither inflationary nor deflationary. As can be seen below, the historical relationship between wage growth in the US and the unemployment rate shows the risk is skewed towards higher wages. The historically low level of unemployment justifies potentially higher wage growth. In 2017, this component should play a significant role in inflation dynamics, pushing core inflation to higher levels.

Looking at a longer perspective, there is an additional factor that could drive inflation higher for the foreseeable future: input prices. After the entry of China into the World Trade Organisation, the world became used to declining costs. Now, wages in China appear to be rising. The chart here shows the progression of OECD labour cost indices across China, the US, the eurozone and the UK: the most recent reliable data for China ends in 2014, and even then labour costs had experienced a massive increase. No wonder China embarked on a set of repeated currency devaluations over the past 18 months in order to remain competitive.

Year over year variation in producer price index versus commodity index and OECD labour cost index

Looking at a longer perspective, there is an additional factor that could drive inflation higher for the foreseeable future: input prices. After the entry of China into the World Trade Organisation, the world became used to declining costs. Now, wages in China appear to be rising. The chart here shows the progression of OECD labour cost indices across China, the US, the eurozone and the UK: the most recent reliable data for China ends in 2014, and even then labour costs had experienced a massive increase. No wonder China embarked on a set of repeated currency devaluations over the past 18 months in order to remain competitive.

US wage growth versus unemployment rate (2016 data points in darker squares)

In addition, there is the impact of the rising US dollar. Donald Trump is now sitting in the Oval Office and commodity prices are already on the rise; the combination of these trends leads us to believe that the era of low input prices is over. It does not mean that inflation will suddenly jump, but the trend in developed economies is skewed towards more inflation in the next decade, not less.
Growth is on the cards

Despite all the elements that have been mentioned so far, the game changer for inflation remains growth. In order for there to be a significant, long-lasting period of inflation, the world needs stronger economic growth. Should growth exceed its potential for a large enough group of countries, inflation will rise.

The graph here compares the evolution of our estimates for potential growth in the US and the eurozone with their respective GDP growth rates. The growth target for the US is around 2% while the eurozone’s is about 1%.

What helped inflation reach higher levels over the 2005-07 period was the sustained rate of GDP growth above potential growth. Another comparable episode is 2009-10, where CPI rose while growth remained above its potential level.

More recently, growth rates have failed to stay consistently above the reference line. In order to see a period of sustained inflation, the world needs positive growth momentum across all regions; we believe we have reached that point.

Actual vs. potential GDP growth: US and eurozone

Growth does not need to be especially strong; it just needs to be well spread enough. The swing factor in this equation used to be the emerging world: emerging countries’ growth momentum faded in the aftermath of the 2013 “taper tantrum” as the US dollar started rising. Now, the situation across emerging markets seems to have stabilised; again, the recovery in commodity prices is both a sign of this stabilisation and a contributing factor to it.

Why do we think that we are about to have a persistently higher level of growth? The simple answer is that we expect there to be public spending programmes, which should in turn lead to a normalisation of investment across the developed world. What is unusual in the current economic cycle is that the significant deleveraging by corporates and certain governments recently has kept investment subdued at best. This phenomenon has held back the US and European economies, which partly explains why the Fed kept on postponing its rate hikes. Now, with US consumer confidence having reached high levels, fiscal policy could be the spark needed to move GDP growth to higher levels.
April/May; Germany will elect its Bundestag members in September.

Geert Wilders’ PVV party is well placed to become the country’s leading party. If the risk of the AfD becoming the number one party in Germany is remote, the French FN is indeed expected to come first and will probably react to record popularity amongst voters. Marine Le Pen will clearly come with a “more spending” type of programme. She is, however, not the most likely candidate to win and her competitor – Mr. Fillon – actually has a programme to cut spending. Again, the political agenda is likely to dictate the breadth of this wave of rising public expenditure.

Political risks, with the threat of a eurozone exit, mean monetary policy is likely to remain accommodative in 2017. However, in the US, the shift from monetary policy to fiscal policy as a growth support will be slow and probably spread over a decade. Not all governments will be able to raise spending: not all countries undertook the necessary deleveraging that has made it possible for the US to contemplate raising government spending over the next four years. Additionally, in the eurozone, both Wilders and Le Pen have made exiting the euro area their priority, and that is likely to unsettle markets. The Brexit vote may have been uncharted territory but an actual eurozone country leaving the euro area would be clearly problematic. For this reason, the European Central Bank and the Bank of England will be monitoring the situation with caution and will be slow to change their accommodative monetary policy stances.

On a brighter note, our understanding of the emerging world shows that it is set on an improving track. The gap that opened up between emerging and developed countries in 2013 has almost closed. This is good news for world growth.

Three forces explain this phenomenon: first, the US dollar has stabilised recently after a sharp rise that unsettled the emerging world. Second, the Chinese government then unleashed significant fiscal stimulus and proceeded to make several adjustments to the exchange rate to boost demand. Finally, many emerging economies are commodity producers and the stabilisation and subsequent rise in various commodity prices have helped this set of countries.

Even if Chinese stimulus is likely to fade, we do not expect the US dollar to go through another round of sharp increases. Furthermore, our view is that even if commodity prices do not progress, they will remain stable. These factors, combined with improvements across developed markets, should continue to fuel the recovery in the emerging world. However, the potential trade war that seems to be rising after the election of Donald Trump will take a toll on emerging markets most dependent on exports – among them, China. This should not, however, derail the emerging market recovery.

Unigestion growth nowcasters

Source: Unigestion

Important information
This document is addressed to professional investors, as described in the MiFID directive and has therefore not been adapted to retail clients. It is a promotional statement of our investment philosophy and services. It constitutes neither investment advice nor an offer or solicitation to subscribe in the strategies or in the investment vehicles it refers to. Some of the investment strategies described or alluded to herein may be construed as high risk and not readily realisable investments, which may experience substantial and sudden losses including total loss of investment. These are not suitable for all types of investors. The views expressed in this document do not purport to be a complete description of the securities, markets and developments referred to in it. To the extent that this report contains statements about the future, such statements are forward-looking and subject to a number of risks and uncertainties, including, but not limited to, the impact of competitive products, market acceptance risks and other risks. Data and graphical information herein are for information only. No separate verification has been made as to the accuracy or completeness of these data which may have been derived from third party sources, such as fund managers, administrators, custodians and other third party sources. As a result, no representation or warranty, express or implied, is or will be made by Unigestion as regards the information contained herein and no responsibility or liability is or will be accepted.

All information provided here is subject to change without notice. It should only be considered current as of the date of publication without regard to the date on which you may access the information.

Past performance is not a guide to future performance. You should remember that the value of investments and the income from them may fall as well as rise and are not guaranteed. Rates of exchange may cause the value of investments to go up or down. An investment with Unigestion, like all investments, contains risks, including total loss for the investor.

Read our latest investment thinking online: www.unigestion.com/publications

Unigestion SA | 4/4