SUMMIT 2019

Victory over inflation?

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Was told it was good to start with a quote

This one doesn't have a lot to do with the rest of the presentation, other than being awesome

The first panacea for a mismanaged nation is inflation of the currency; the second is war. Both bring a temporary prosperity; both bring a permanent ruin. But both are the refuge of political and economic opportunists.

- Ernest Hemingway

Global Inflation has been low for a long time

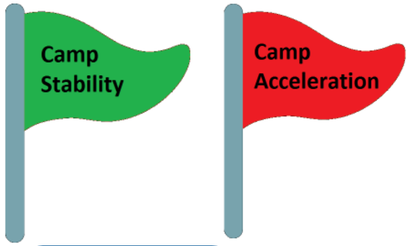
Many central banks have focused on ABD – Anything But Deflation

- Typical late cycle inflationary pressures have yet to manifest themselves
  - A tight labor market has now supported upward wage pressure
  - Prices are not responding in tandem with increased labor cost
- Is this lack of inflation going to persist for the remainder of the cycle?
  - If so, what implications may that have for the economy and markets?
- If inflation does pick up what are the likely implications?
- What are the inflationary risks in the longer term?

Drivers of inflation

Econ 101 checklist

CliffsNotes



Drivers of inflation

Anticipation:

- Recent trends
- Forward expectations

Cost push:
Decrease supply of goods where producers pass increased costs on to consumers.

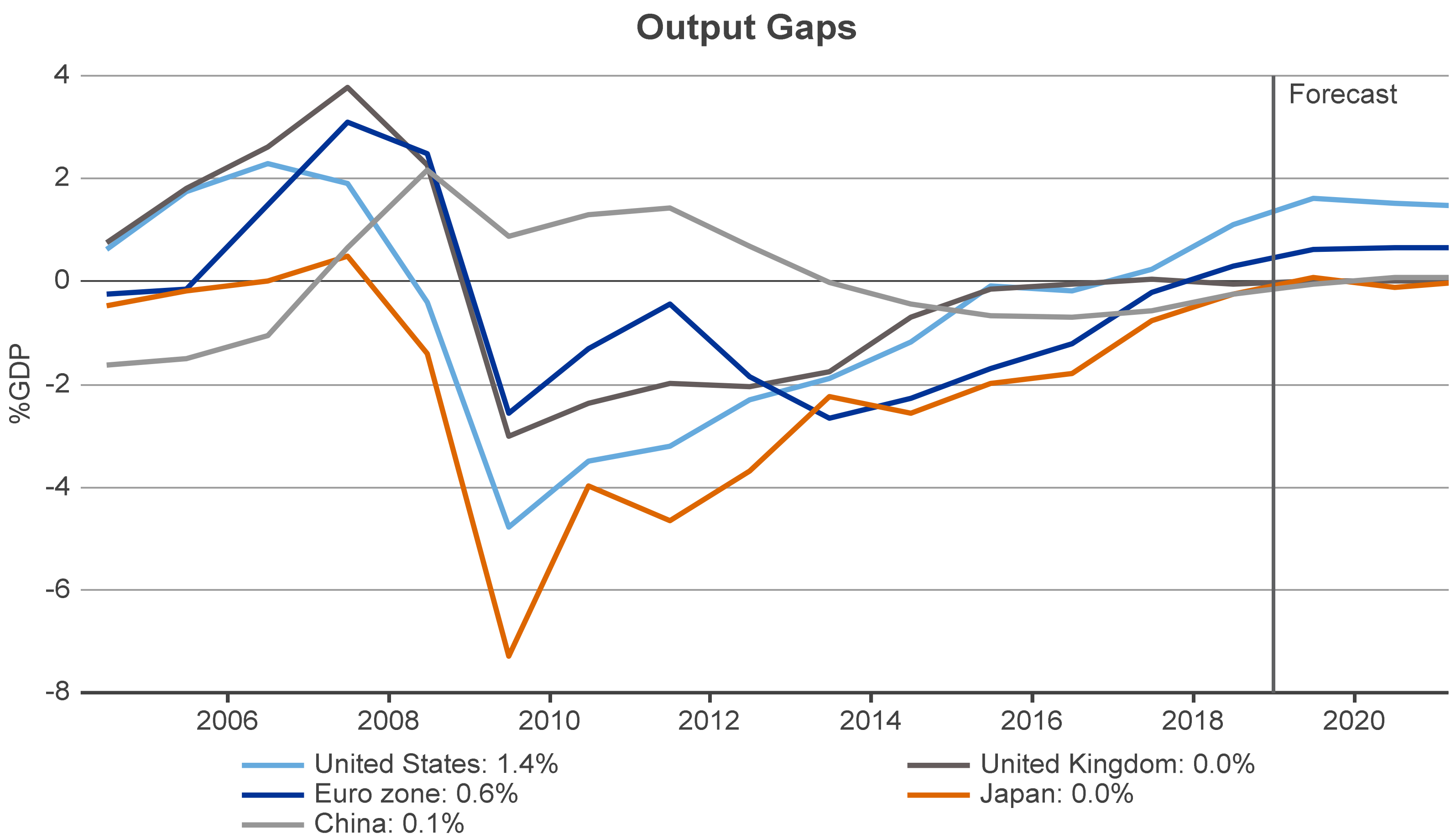
- Increase taxes/tariffs
- High per-unit labor cost
- Currency (weaker exchange rate = higher prices to buy same import)
- Raw material prices (e.g. increased oil price)

Demand pull:
Increased aggregate demand for goods.

- Low unemployment
- Lower interest rates
- Increased money supply
- High wages
- Rising house prices

Lack of spare capacity

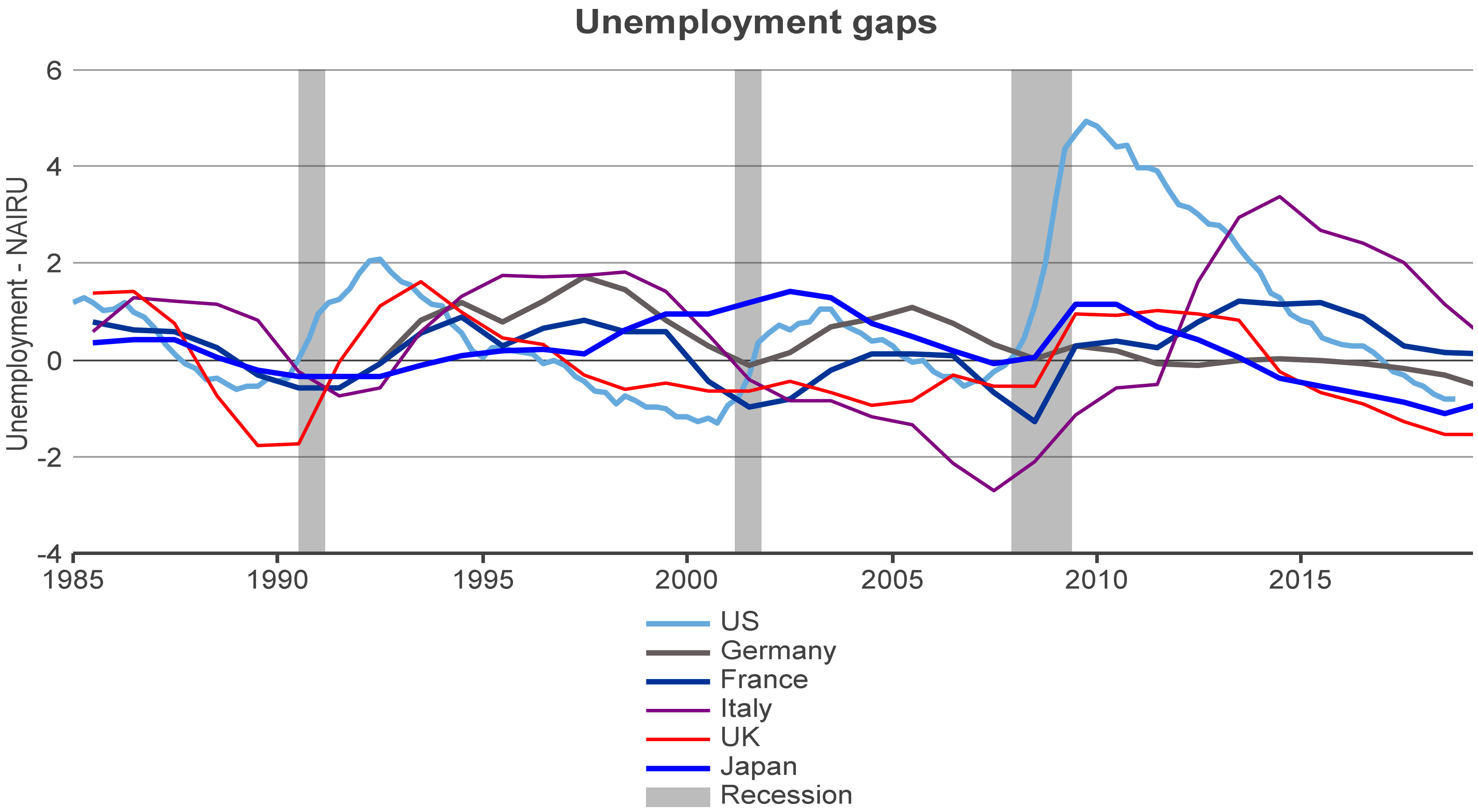
GDP of major economies now at or above potential



Source: Thomson Reuters Datastream, 19

Lack of spare capacity

Labor market is tight for major economies

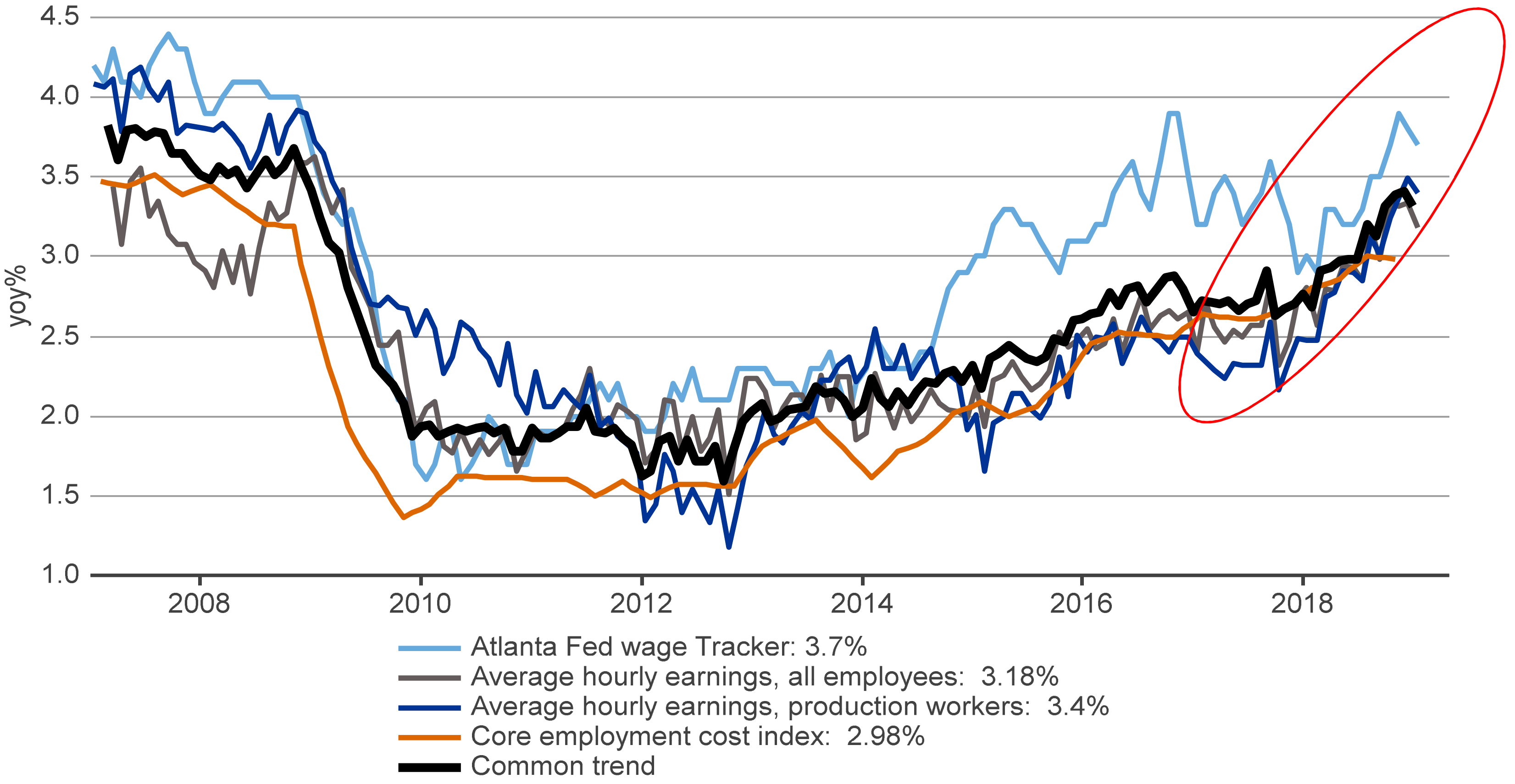


Source: Thomson Reuters Datastream, Q1 19

Increased demand pressure

Wages are rising in the US

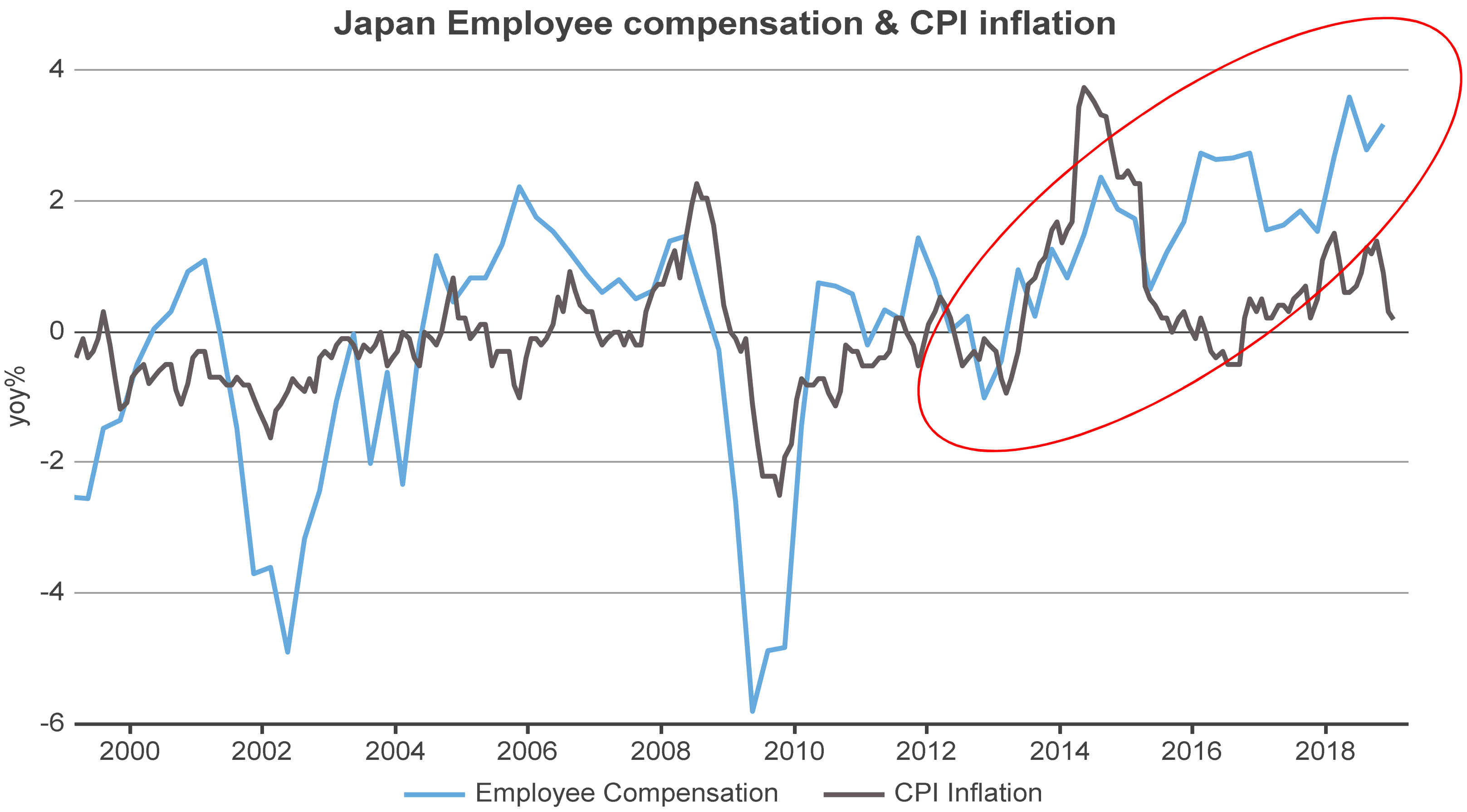
US Wage Growth



Source: Thomson Reuters Datastream, Jan 19

Increased demand pressure

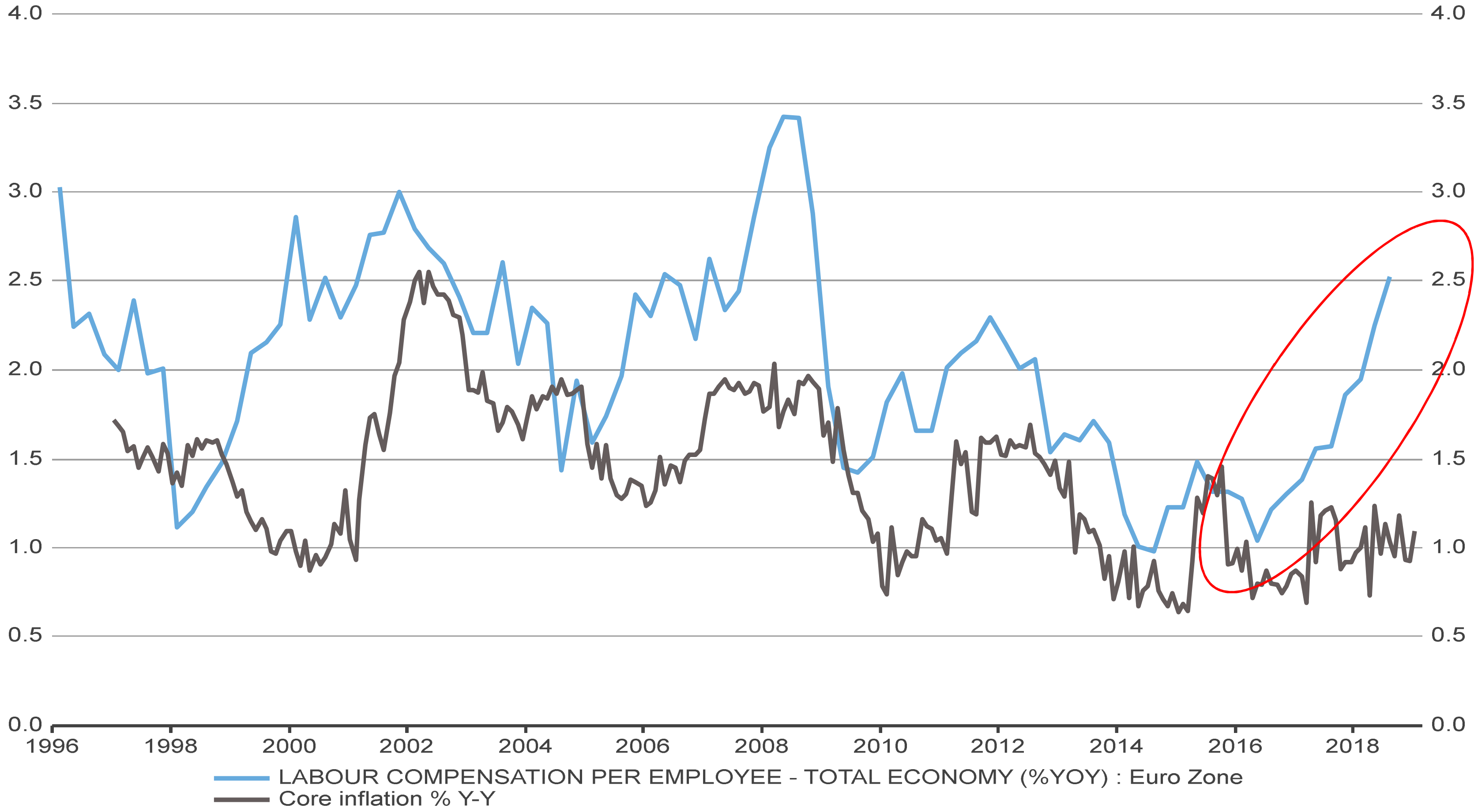
Wages are rising in Japan



Source: Thomson Reuters Datastream, Q4 18

Increased demand pressure

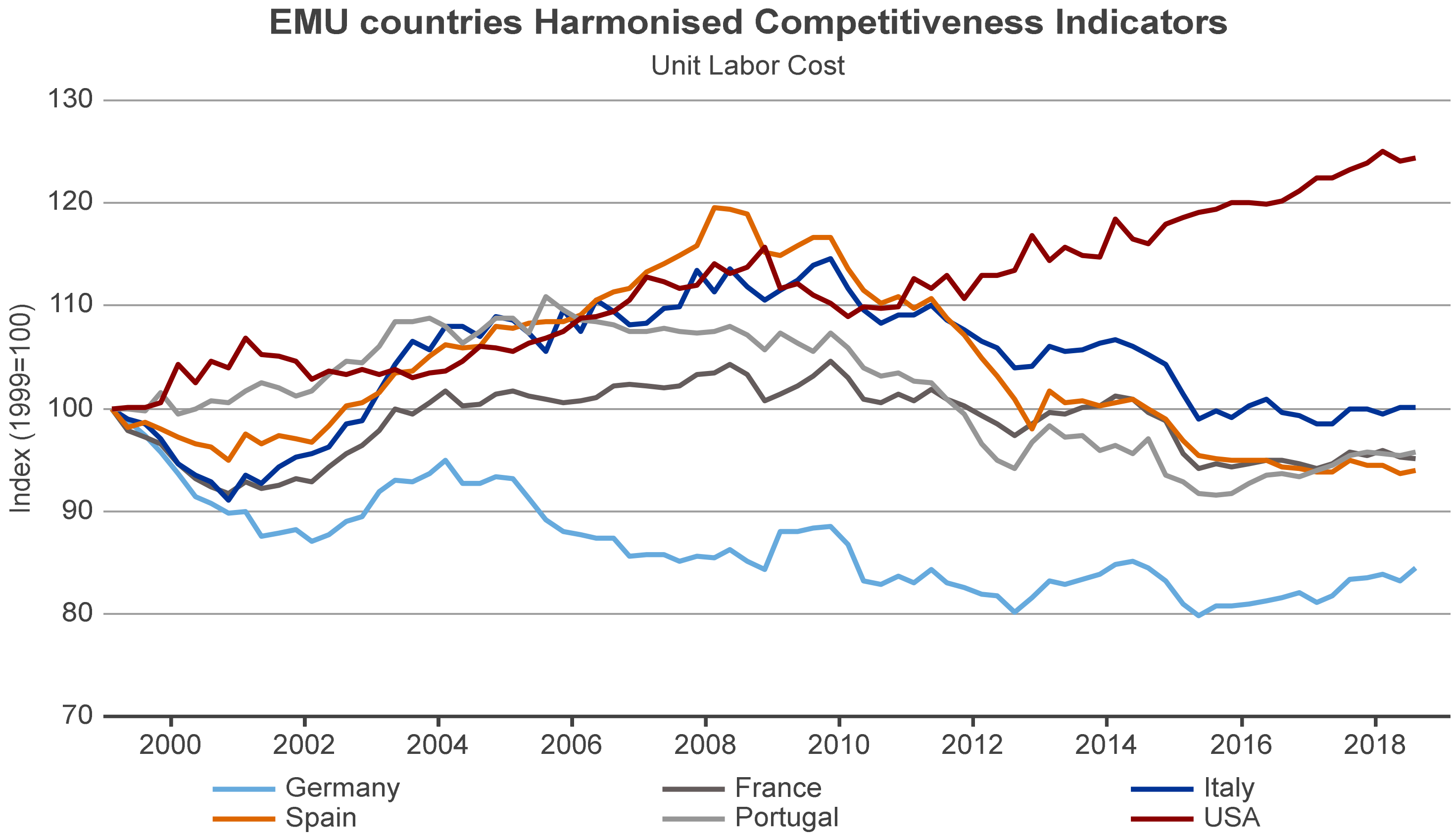
Wages are rising in the Eurozone



Source: Thomson Reuters Datastream, Aug 15, 2018

Increased cost pressure

Labor costs are rising even accounting for productivity gains

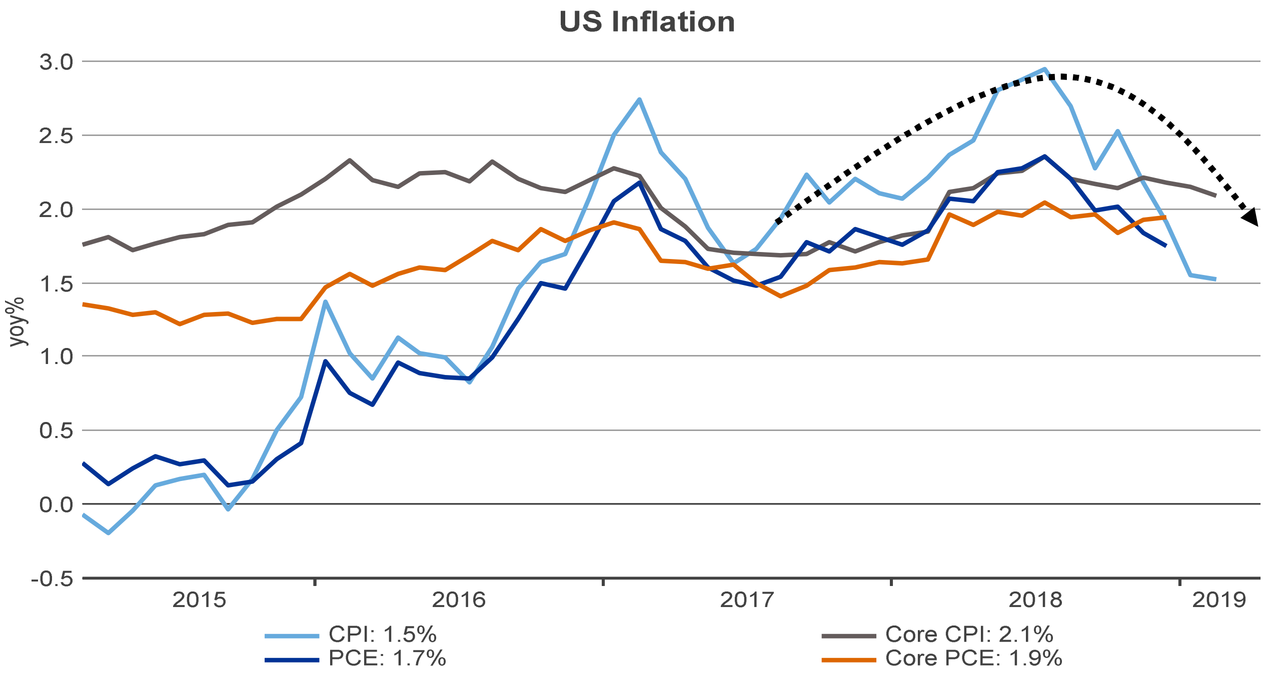


Source: Thomson Reuters Datastream, Q3 18

Case for accelerating inflation

Recap

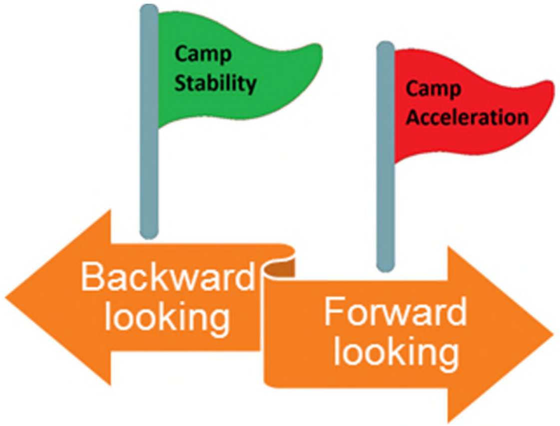
- There's little spare capacity globally
- Ingredients for accelerating inflation are here
  - Some evidence that wage version of Phillips curve is working
  - However, mixed evidence for price version of Phillips curve



Source: Thomson Reuters Datastream, Feb 19

Transitory effects

Boosts to future inflation



Headwinds before

> Global bias to tightening

> USD strength lowers import prices

> Oil price weakness to low of ~$45/bbl

Tailwinds in future

> Global shift to dovishness

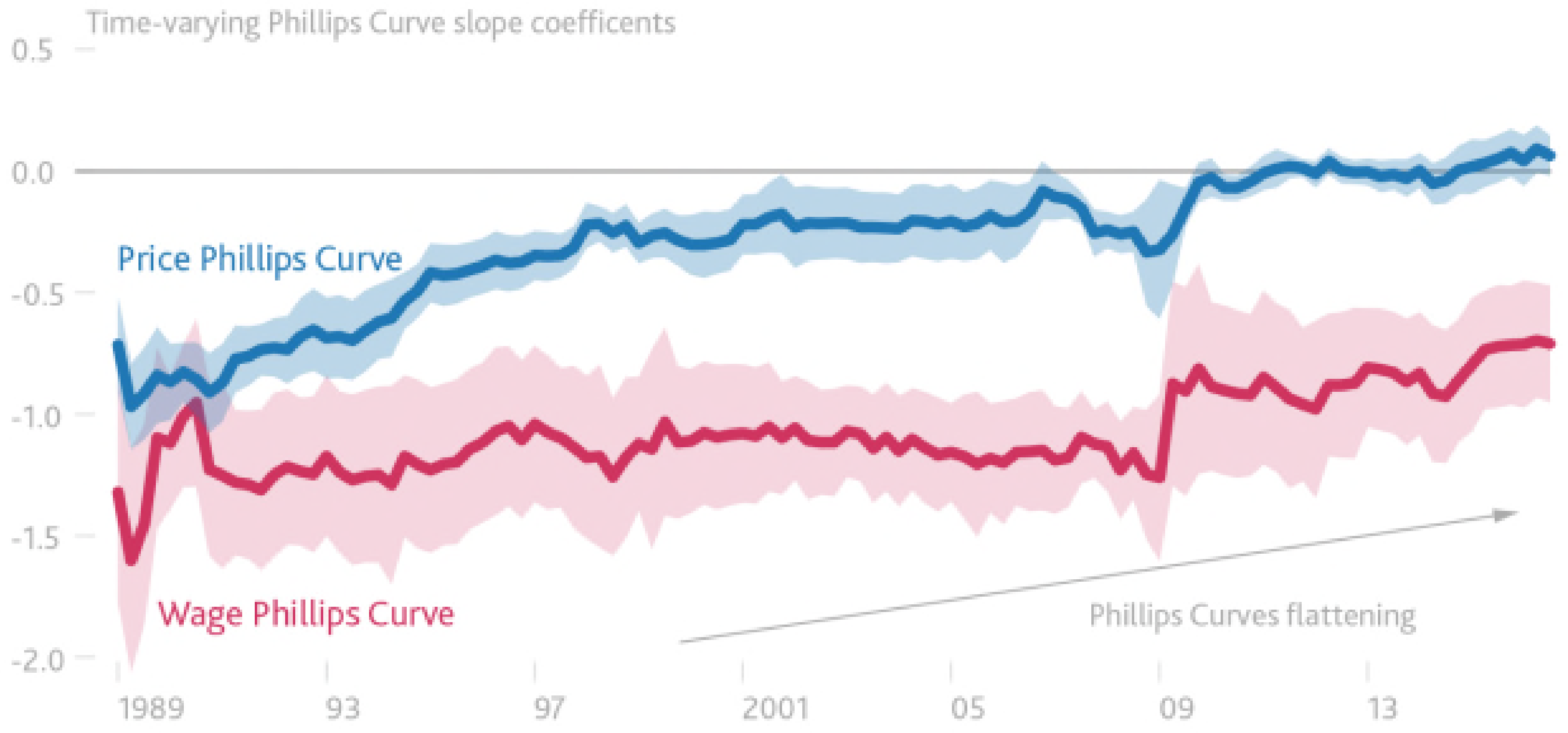
> USD rally likely to end in 2019

> Oil price likely rebound to ~$75/bbl

Source: Thomson Reuters Datastream, Feb 15, 2019

Case for stable inflation

The price version of the Phillips curve is broken



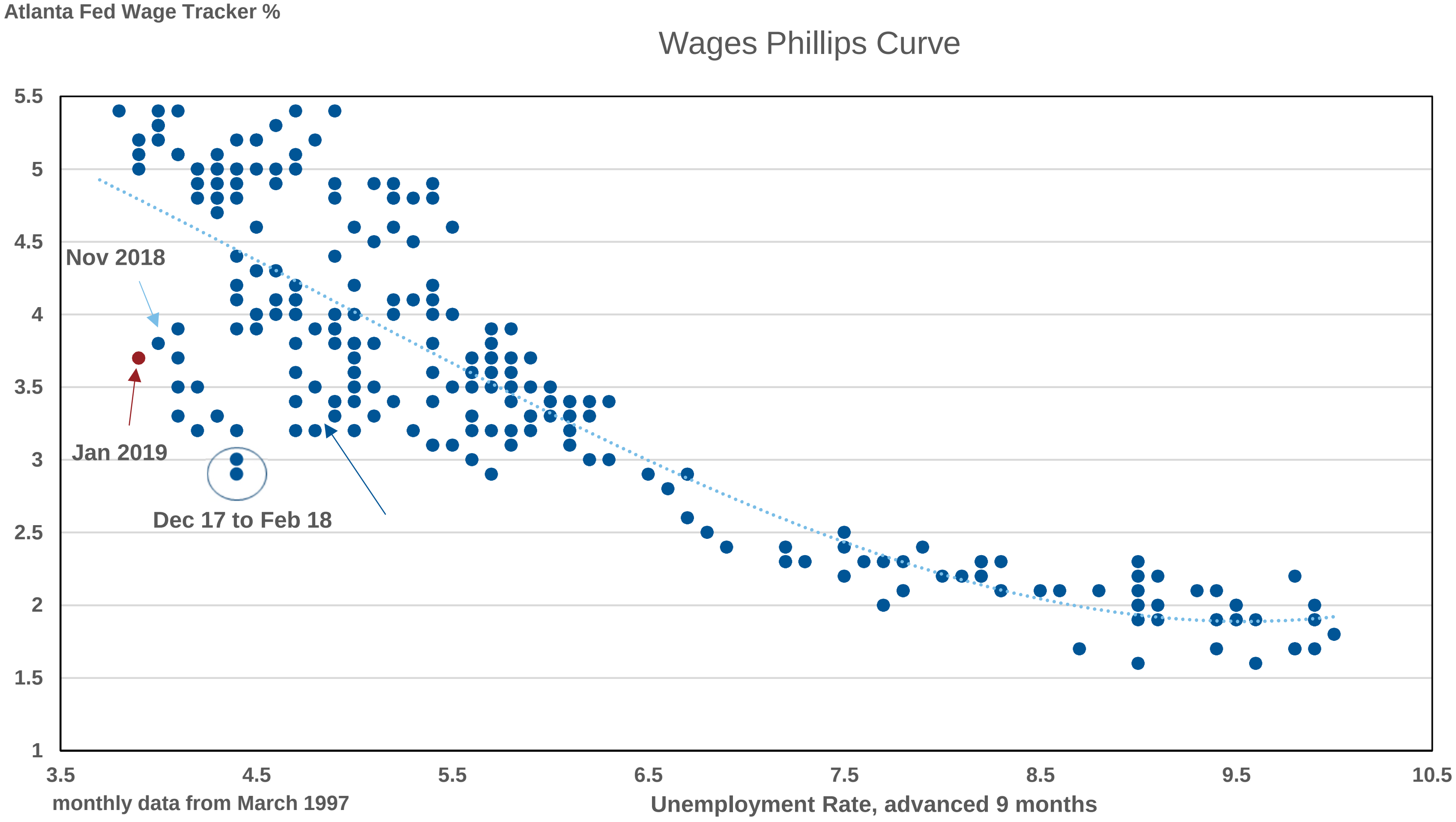
Source: BIS 87th Annual Report.

Rolling 15-year window estimates and confidence bands from a panel of G7 economies.

Inflation: US Phillips curve

Gap to Phillips wage curve relationship diminishing

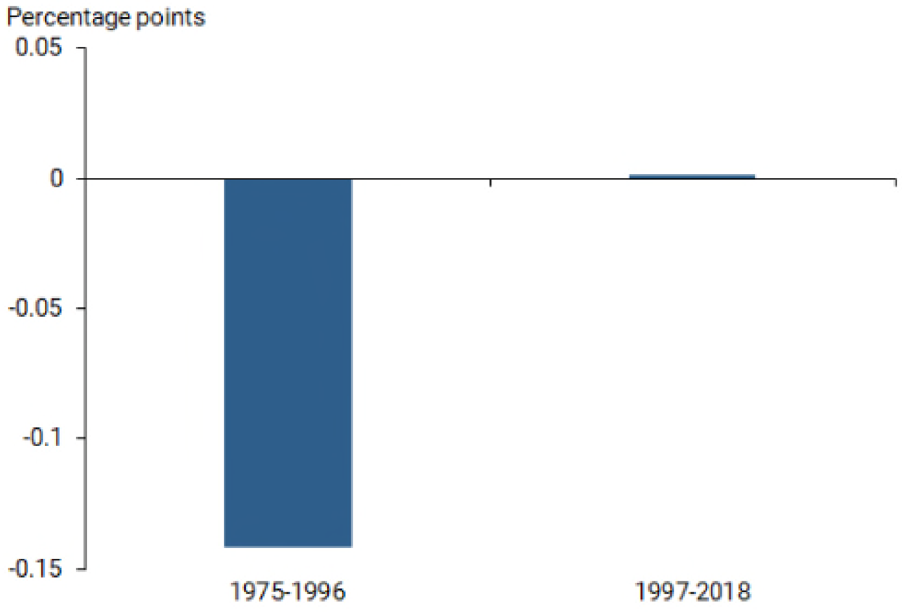
Camp Acceleration



Broken price Phillips curve

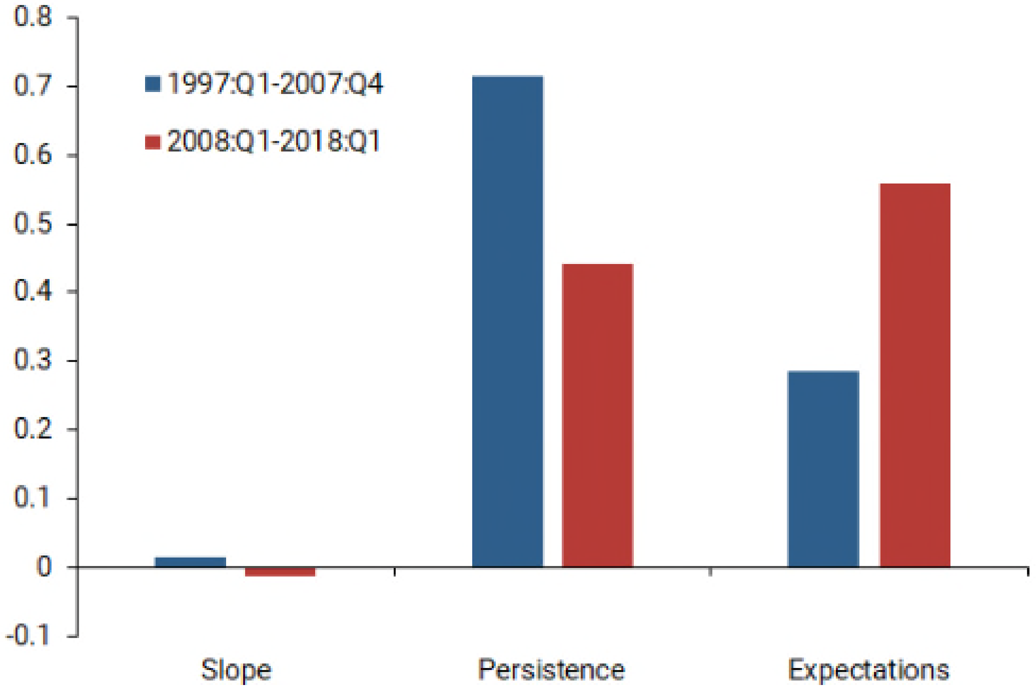
Anchored expectations dominate spare capacity

Link between inflation, economic slack has weakened



Note: Weight on unemployment gap in Phillips curve.

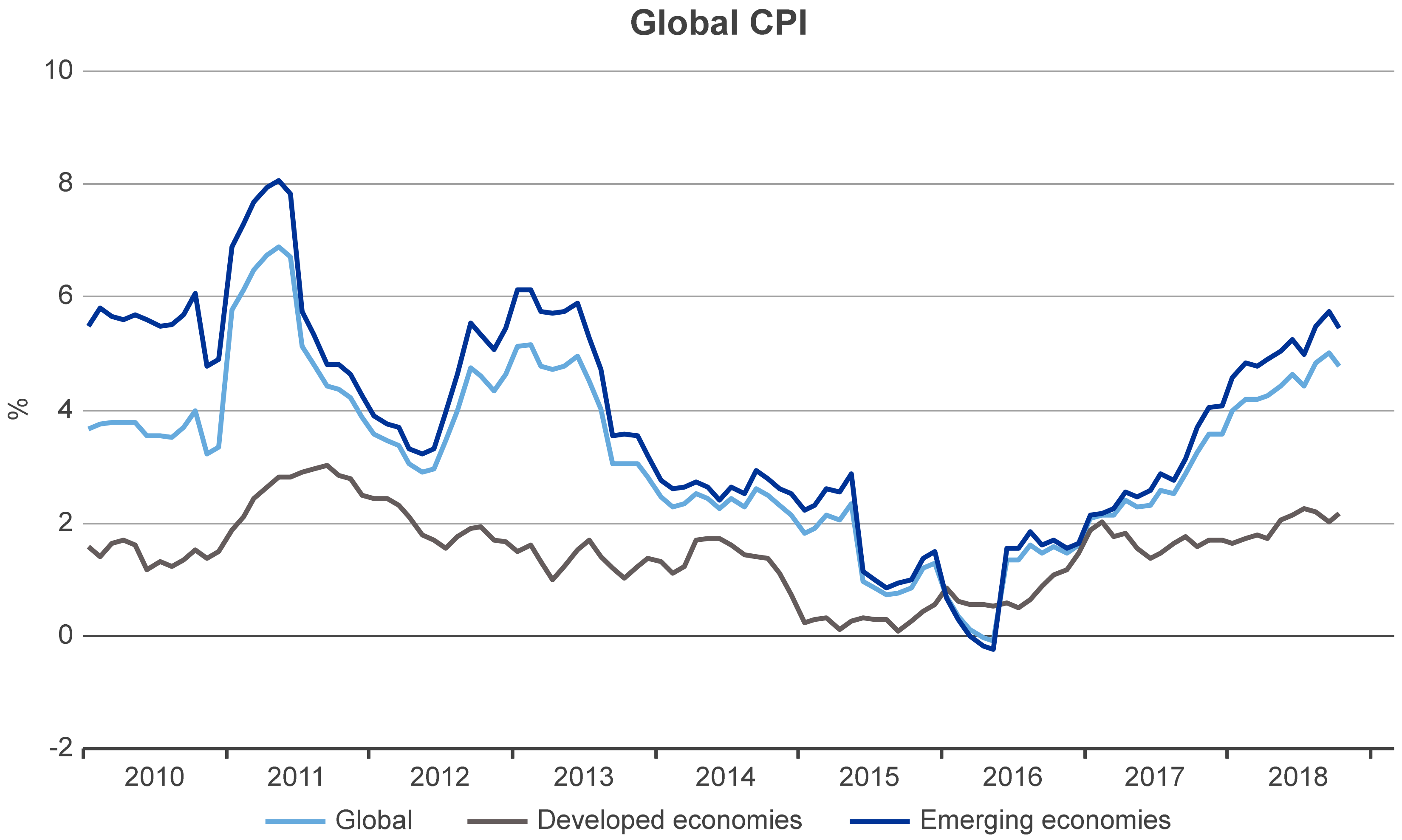
Contributors to Phillips curve changes before, after recession



Source: https://www.frbsf.org/economic-research/publications/economic-letter/2019/february/inflation-stress-testing-phillips-curve/

Persistence

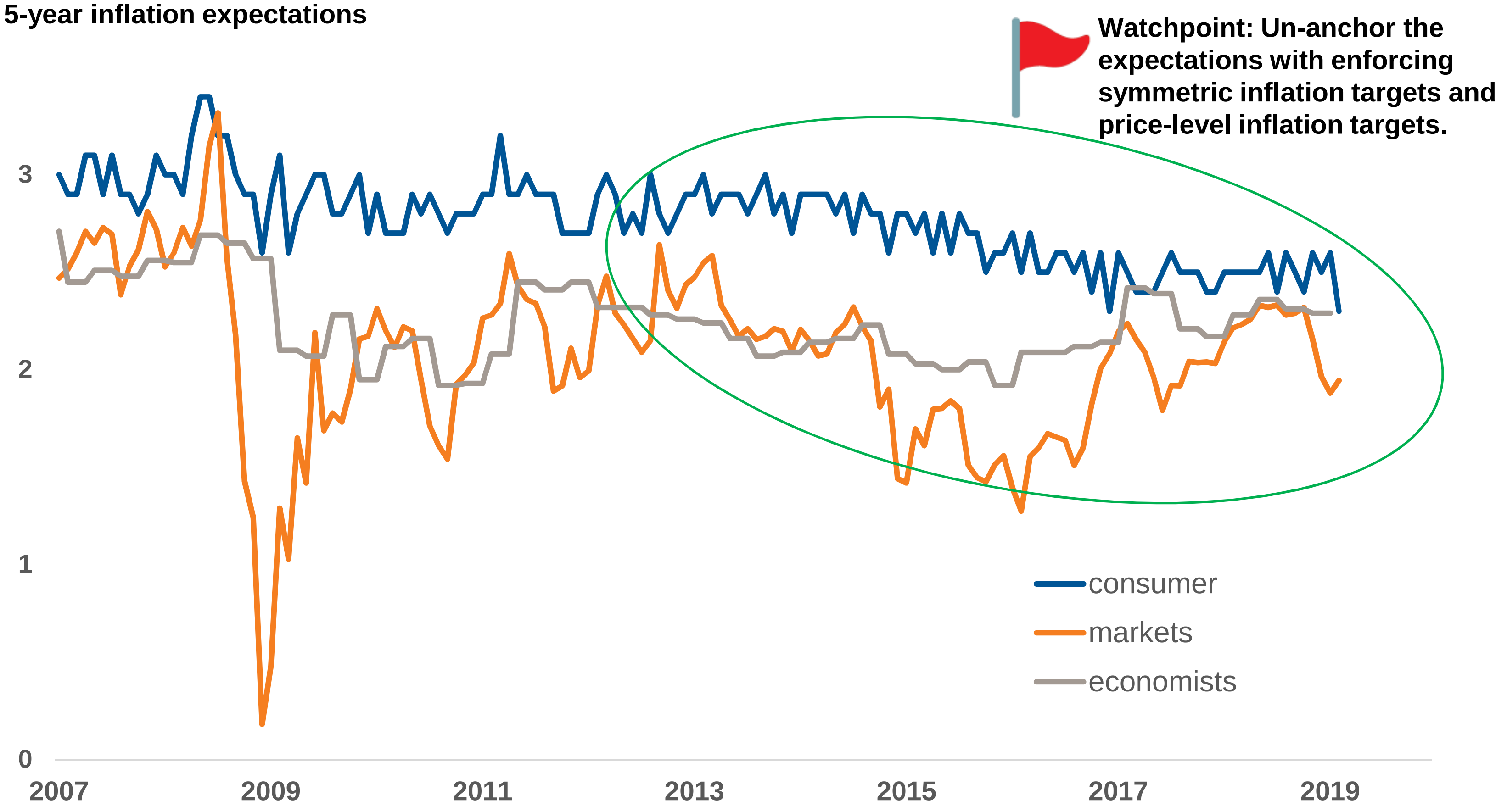
Mixed: general rising, but some softening recently



Source: Thomson Reuters Datastream, Oct 18

Expectations

Inflation expectations are low



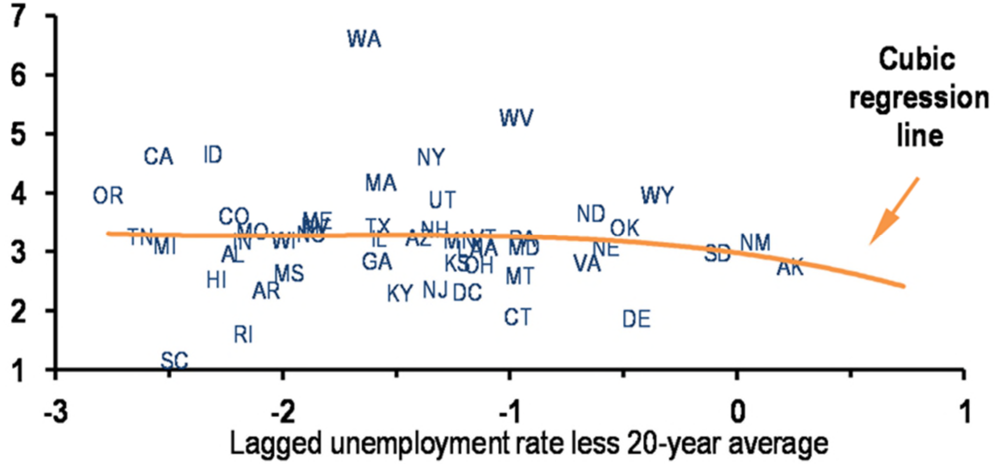
Note: **Consumer** – University of Michigan survey. **Markets** – inflation swaps. **Economists** – Survey of Professional Forecasters.

Inflation likely to be low, until it is not

No major signs that is about to change in the US

Figure 4: Wage growth vs. unemployment gap across states

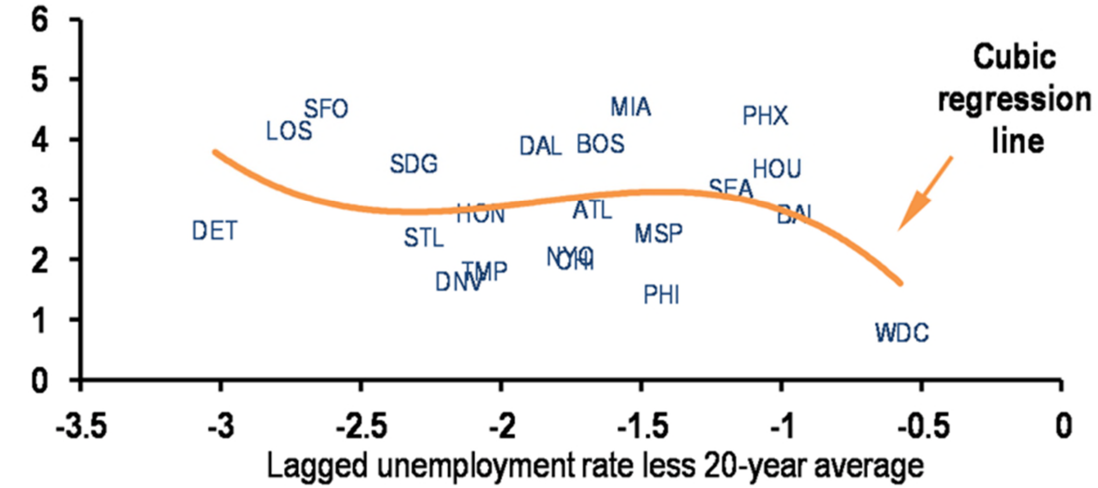
Average weekly wages, 4qma, %oya



Source: BLS, BEA, J.P. Morgan

Figure 5: Services inflation vs. unemployment gap across metros

CPI services, %oya

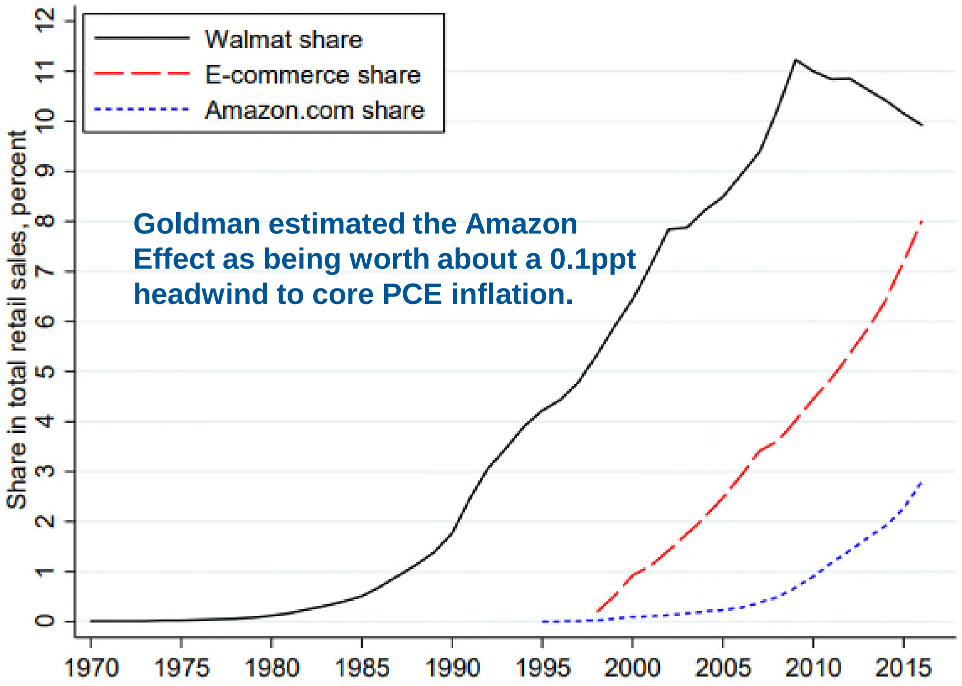


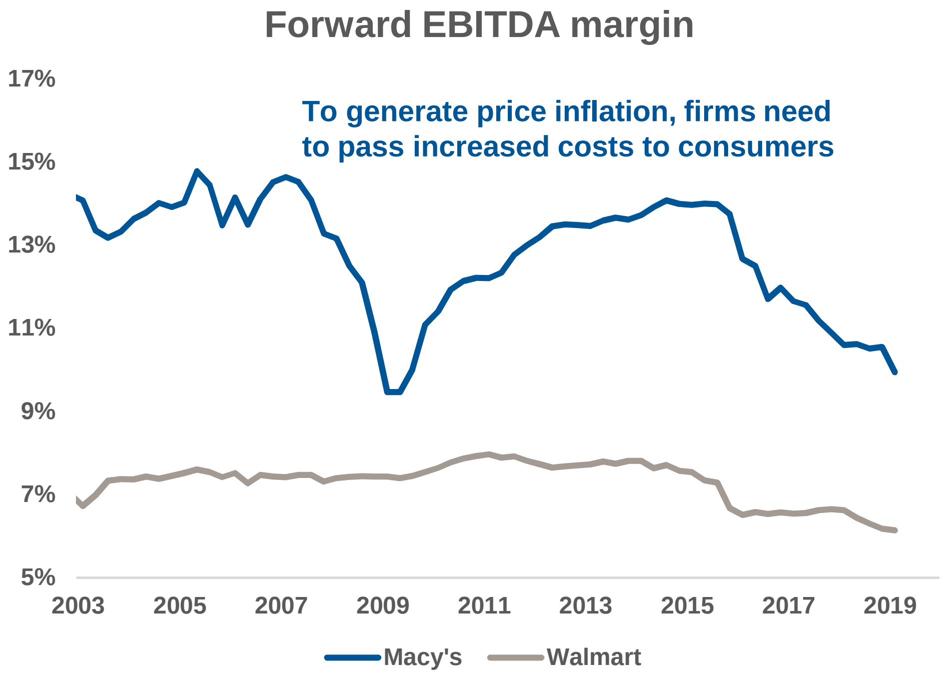
Source: BLS, BEA, J.P. Morgan

Lack of pricing power?

Technological disruption and disinflation

Camp Stability



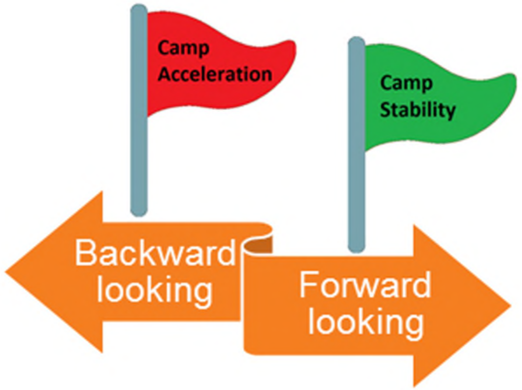


Implication for equities: Rock and a hard place

- Wage inflation but no pricing power / price inflation = bad for earnings
- Wage inflation and pricing power / price inflation = restrictive Fed

Transitory effects

Drag on future inflation



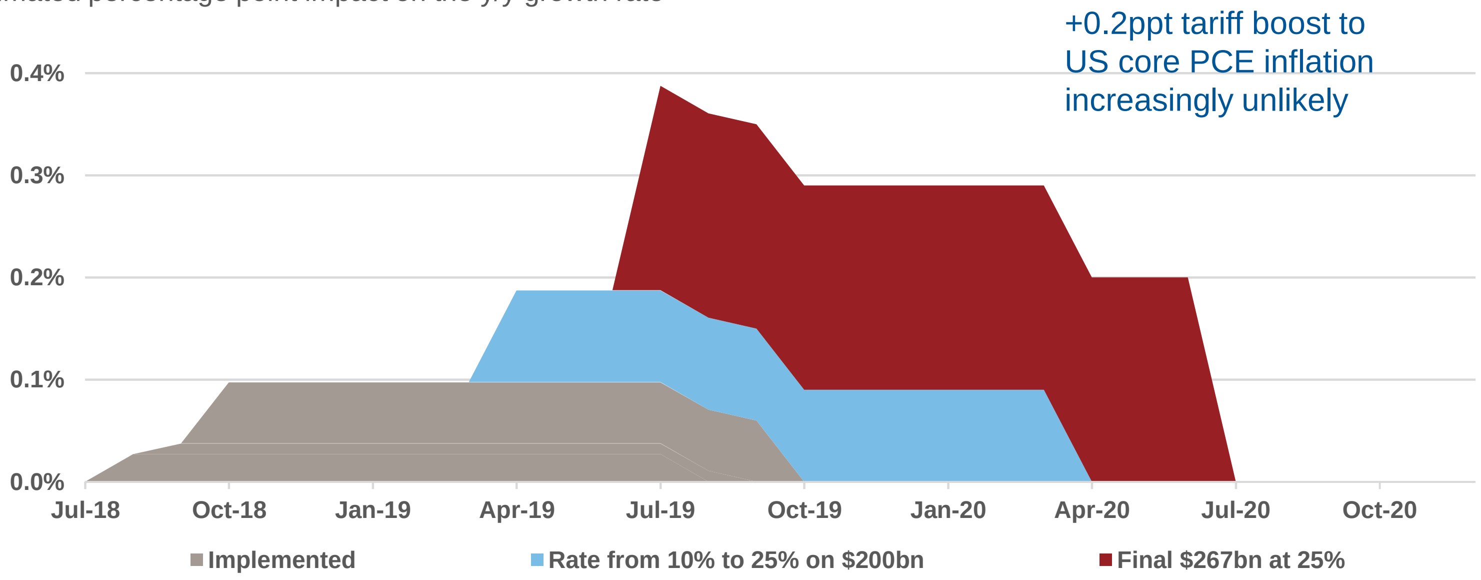
<u>Tailwinds before</u>

> Trade war escalation

<u>Headwinds in future</u>

> Trade war resolution

Impact of US-China tariffs on core PCE inflation
Estimated percentage point impact on the y/y growth rate



Source: Russell Investments estimates as of December 2nd 2018.

Case for stable inflation

The likely path over the next twelve months

- The impact of spare capacity on inflation has been muted.
- Recent inflation trends and forward inflation expectations matter more. These drivers support stable inflation.
- Risks:
  - Un-anchoring of expectations
  - Nonlinear response to inflation

What does this mean for markets for the next year?

Hard to see the massively bullish argument for global equities, US in particular

Stable inflation scenario

- Fed stays on sidelines
  - Phillips wage curve likely holds
  - Labor costs rise
- Low inflation is the result weak pricing power
- Higher labor cost + flat prices = lower margins

High valuations and lower margins likely to restrict equity market upside

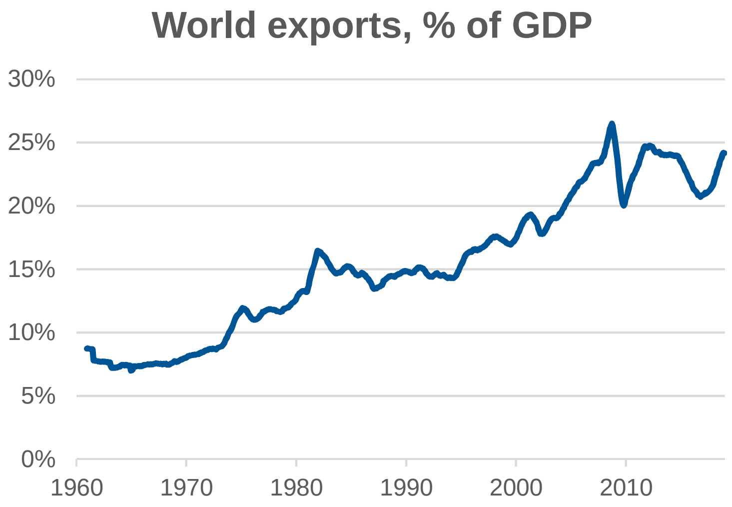
Accelerating inflation scenario

- Fed starts raising rates again
- Yield curve inverts
- Recession countdown clock starts ticking

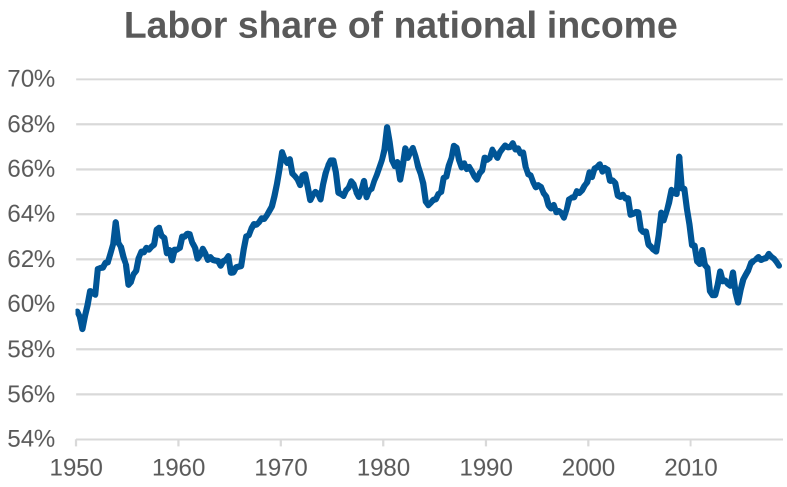
Not a lot of great things happen in equity markets when the yield curve inverts

How about the longer term

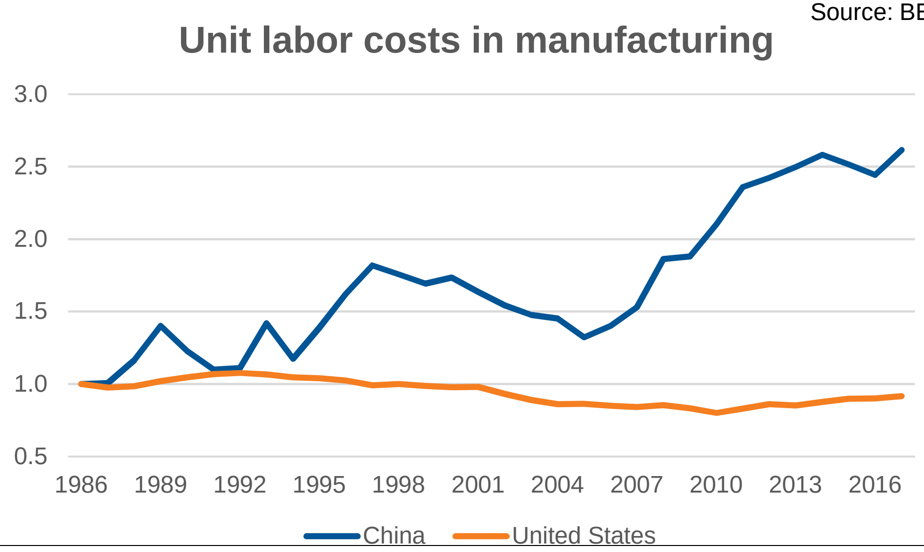
Secular disinflationary forces have dominated for a good long while…



Source: IMF, World Bank



Source: BEA

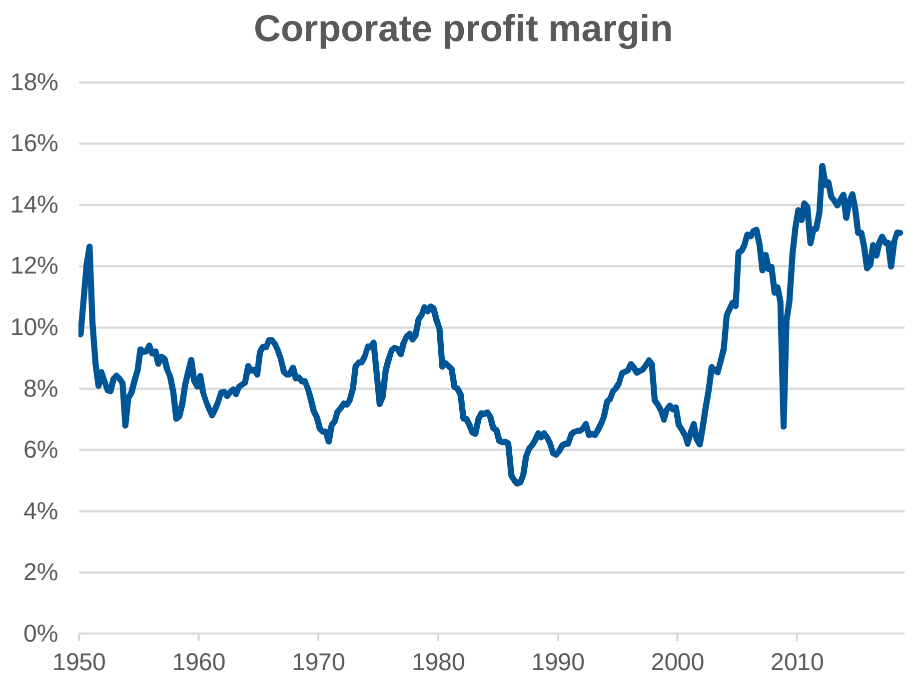


source: Conference Board

Margins likely to come under pressure

Profit margins mean revert

Source: BEA



Source: BEA

Higher profit margins have been driven in part by low labor cost and lower taxes

How likely is it that those trends will continue?

Longer term

Inflation is likely just dormant not dead

Reasons to believe in higher inflation in the cycles to come

- Many disinflationary trends are getting long in the tooth
- Those trends have contributed to political polarization
- This generation of central banker has only experienced low inflation
  - The “Pease Theory” on inflation cycles

- Actions to reduce political tension are very likely to be inflationary

Questions we said we would answer

With the understanding that there are no absolute known truths about the future

- Is inflation dead? No
- Are global central banks prepared for the shift from stimulation growth to curbing in inflation? No
- Is ensuring that growth continues more important than managing inflationary pressures? No

Disclaimer