GADD INFINUM

Market Insight

WINTER 2018

Inflation ... are you there ?

I have never seen so many references to Goldilocks in the market strategists' scenarios for 2018. Such a strong world economy with inflation at bay ... until this horrid statistic showing a much higher than expected increase in wages in the United States in January. It was enough to freeze the optimism of the "Goldilockers", spooked by this new piece of overheating evidence which just revealed how sensitive to interest rates world stock markets can be. We keep a close eye on the bond markets for they will dictate the ebb and flow movement towards equity markets. Caution is needed, especially since Central banks are beginning to look at asset prices to measure an inflation threat which is probably not just some intellectual fantasy...

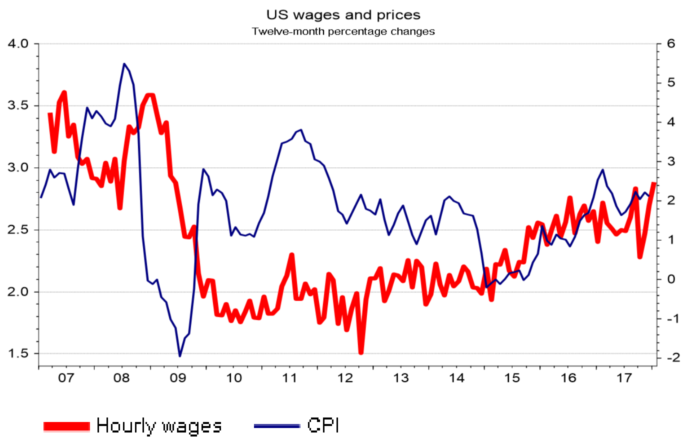
Ubiquitous Goldilocks ?

Look on the Internet for the number of searches associated with the word "Goldilocks": it is at its peak. I've never seen so many references to the little blonde girl who gets lost in the woods, takes refuge in the house of 3 bears and finds happiness with the bowl of porridge of the teddy bear, that is "neither too hot, nor too cold, just right. " A global economy that is riding the wave of growth, avoiding the geysers of overheating and the sea ice of deflation is the dream for investors: the steady growth announces great corporate earnings rises and the controlled inflation avoids excessive tightening of monetary policies.

The big question for financial markets in 2018 is: given the strong global growth, or even too strong in some key countries like the United States, will we witness inflationary pressures and, above all, tensions on bond yields? My answer: a lasting inflationary shock seems unlikely, but a cyclical rebound in inflation is not to be excluded. And it will be necessary to cope with the hypersensitivity of stock markets with the slightest shudder on bond yields.

A single piece of data sent stock markets into a tailspin on Monday, February 5: the shock came from a higher than expected increase in wages in the USA in January, as shown on the red curve in graph 1.

1. The wage shock triggers the collapse of stock markets



Does this 2.9% rise in hourly wages herald a return to inflation? A detailed analysis of the figures shows that this rise is undoubtedly linked to a decrease in the hours worked during the month of January, induced by the cold wave that raged at the beginning of the year, as well as the partial closure of several government agencies for lack of funding. It is therefore likely that the factor that triggered the fall will prove to be a statistical aberration ...

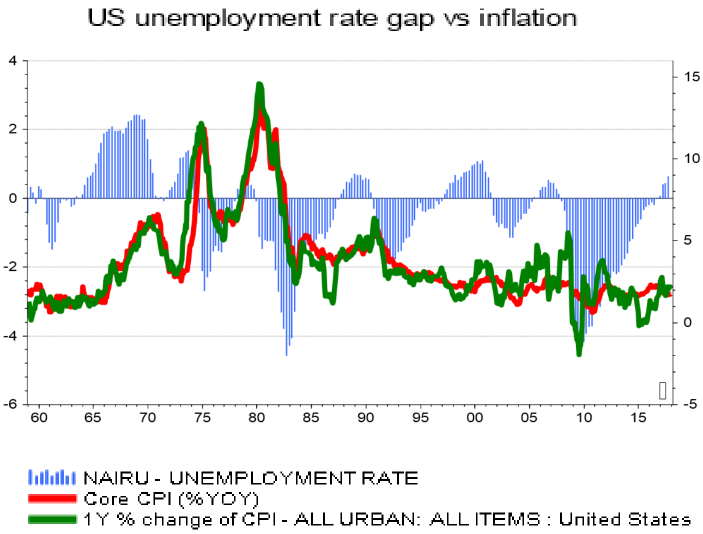
Can we « buy » a fall in unemployment with a little more inflation ?

The growth of the American economy is already very strong today. It will become even more so with the tax cuts heralded by the Trump administration. Currently, the unemployment rate is below its non-inflationary threshold given by the NAIRU: (Non Accelerating Inflation Rate of Unemployment). When the gap between the NAIRU and the unemployment rate is positive (which is the case now), it means that the unemployment rate is below its "natural" threshold and that we are entitled to expect inflationary pressures via salary increases. This positive gap thus decrees a situation of overheating. Does following it allow us to predict inflation? Things are not so simple.

The link between unemployment and inflation is widely debated in economics from the angle of the Phillips curve, the name of this New Zealand economist who, in 1958, observed an inverse empirical relationship between the unemployment rate and the variation in nominal wages. This link came to be exploited by followers of Keynes to advocate policies for stimulating demand through expansive monetary and / or fiscal policies. For these New Keynesians, it would be possible to "buy" a decrease in unemployment by "paying" with an increase in inflation. Monetarists argue on their side that there is no link between these two variables and that any stimulation of demand only causes a rise in inflation, without reducing unemployment. In 2016, former IMF chief economist Olivier Blanchard retorts that the Phillips curve does exist but ... that its slope has become weaker over time. While in the 1970s, a 1% drop in the unemployment rate translated into a 0.7% rise in inflation, the inflationary impact fell to 0.2% today. The explanation given by Blanchard: when inflation is low, employees "forget" to demand wage increases. Among the other possible reasons is the fact that worker insecurity remains high, even when unemployment is low. In addition, the unionization rate is lower today than it was during the 1970s. The reason is simple: the weight of the manufacturing sector has decreased in favor of the service sector, which has much less unionized employees than the former sector. Last but not least, globalization and, more recently, increased robotization of factors of production, act globally as disinflationary factors for both prices and wages.

This lower elasticity between, on the one hand, the gap between the natural unemployment rate and the actual unemployment rate and, on the other hand, inflation, is to be seen in Chart 2. When the blue bars point upwards, the US economy is overheating and inflation is expected to rise. The phenomenon occurs quite well in the 60s and 70s, but to a much lesser extent since the 1980s.

2. Inflation and unemployment in the US: a distorted link



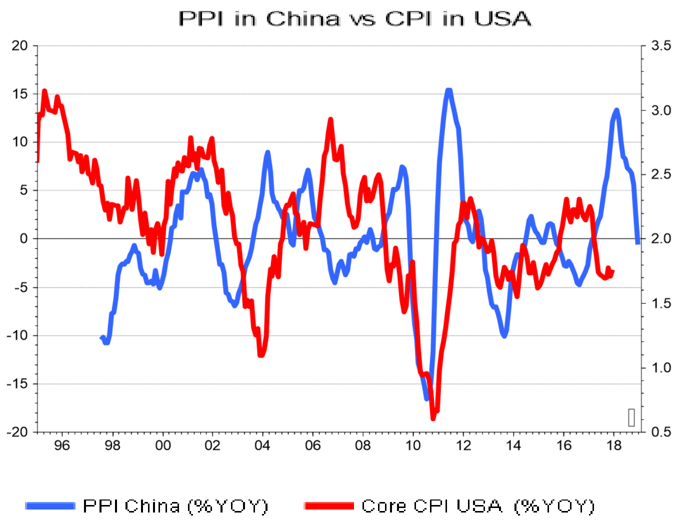
It is not only in the United States where the "inflationary" threshold of the unemployment rate has been exceeded. In Europe, countries like Germany or the United Kingdom are also in overheating territory. Even the 9.2% of unemployment rate expected for this year in France is close to the natural unemployment rate.

In Japan too, actual unemployment is lower than the NAIRU. Here as elsewhere, wage increases are slow and it is funny to note that Prime Minister Abe urges unions to be more determined in their wage requirements! True, the Land of the Rising Sun is known for creating low-skilled jobs, such as that of "packers" of passengers in the subway. Nevertheless, Japan now offers a higher job offer rate than during the peak of the late 80s!

3. Japon : at full speed !

It is more difficult to find relevant statistics on GDP growth in China or on potential GDP, a measure very close to the natural unemployment rate. Leading cyclical indicators are still pointing to solid growth, albeit in decline. This is reflected in the decline in producer prices that some also use to predict inflation ... in the United States, as an illustration of the globalization forces at play.

4. Producer prices in China : to predict inflation in the world ?

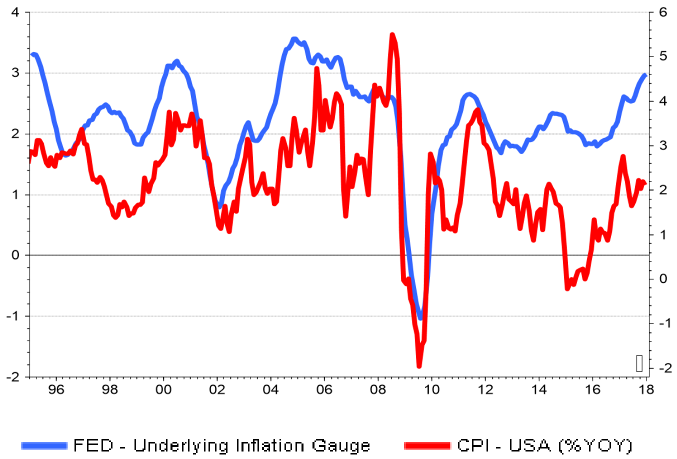


Inflation, yes, but ... which one ?

At first I thought it was a joke when a fellow economist told me about a new measure of inflation computed by the New York Fed that takes into account ... the price of assets! We have to remember that the Federal Reserve has always been very reluctant to counter the speculative bubbles in the financial markets. To be true, former US Central Bank President Alan Greenspan was fond of saying that a speculative bubble can only be proven when it bursts. Today retired, the same President does not hesitate to decree that there is a bubble ... in US bonds!

So yes, the Fed's new Underlying Inflation Gauge includes, hold on, 346 components. Namely, the 223 components of traditional inflation plus 123 economic and ... financial variables: among these, short and long-term interest rates, corporate bonds as well as high-yield bonds, credit to real estate, stocks as well as commodities. The Fed study shows that this indicator is a good predictor of future inflation. What does it tell us today? That announced inflation has reached a peak of 3% that was not seen since August 2006!

5. Fed's new inflation indicator points to overheating ?



In a nutshell: the world economy is going through a period of marked growth. The ups and downs of the stock market in early February shows a change of regime: that of inflation fears related to overheating. In this sense, any new confirmation of sustained growth in the US may be poorly received in the markets. Our relative stock-to-bond valuation model still indicates the 3.75% level as the critical threshold for 10-year bond yields. At this level, the bonds would become attractive vis-à-vis equities. Given the hypersensitivity of global stock markets to interest rate movements since the beginning of February, there is likely to be more turbulences in the stock markets before this critical threshold is reached.

Michel Girardin, *Senior Economic Advisor*

Source : Thomson Reuters Datastream / MacroGuide

Money-market and fixed-income

Global growth leveled off at a strong rate of almost 4% on an annualized basis in the fourth quarter of 2017 and is likely to maintain this pace in the first quarter of 2018. Meanwhile, global inflation as measured by consumer prices rose gradually to more than 3% in 2017, thus undermining deflationary pressures. Central banks are now moving toward a tighter stance, including the Fed, which has raised its key rate from 0.50% to 1.50% in 12 months, and the ECB, which has served clear notice that it will shut down its quantitative easing (QE) program in 2018. Even so, bond yields barely budged in 2017 and did not begin to rise until January. The US 10-year yield is now above 2.85% and the 10-year Bund, 0.70%. We are being careful to keep our bond portfolio's duration low, at 3.5 years. In our balanced portfolio, we are lowering our overweighting of high-yield bonds to 14%; we are raising our weighting of subordinated bank debt and euro zone sovereign debt spread products. We plan to raise our investment grade allocation to 11% if yield opportunities arise in Europe and emerging markets.

Equities

The broad spillover of economic growth to most major countries led to across-the-board gains in the markets in 2017. The MSCI World expressed in USD ended the year up 20%. The markets continued to rally in January, particularly in the US, driven by solid fourth-quarter corporate earnings, before inflation fears triggered a sudden market correction and a return of volatility. In our balanced allocation we continue to underweight the US (15%), which remains overvalued. We are overweighting the euro zone (19%), which is likely to benefit from growth momentum that has not yet been priced in by the markets. We are still bullish on Japan (6%). In emerging markets (7%) our main positions are still China, India, Korea and Brazil. Our favorite sectors are technology, consumer stocks, industry, financial services, and healthcare. In the short term we are cautious on equities, despite the recent correction, and have set up some tactical hedges on the S&P 500 and Euro Stoxx 50.

Currencies

On the political front, there was a clear refusal of populism and a dip in protectionist temptations in the euro zone in 2017. The call for unity by Emmanuel Macron and Angela Merkel, along with clarifications on Brexit, have boosted the case for single currency, which had been undermined by one crisis after another in previous years. The euro gained 14% in 2017 vs. a US dollar that was clearly overvalued, and it continued to post gains in January. We have taken a hit on our long USD/EUR position since the start of last year but were unable to unwind our position at our target rate of USD 1.15. We are to keep this target in place for 2018.

Outlook

In 2017 most investors underestimated the extent and quality of global growth. This is now synchronized and has shown improvements in terms of productive investment and profitability. So it makes sense that the higher prices driven by economic growth are leading to an uptick in inflation, and that is likely to continue in the coming months. Against a general backdrop of tighter monetary policy, the yield curve will gradually steepen, and bond markets will be the main losers of this change in paradigm. Meanwhile, keeping interest rates so low was one of the main drivers of the equity market rally, and the somewhat rapid rise in bond yields are beginning to trigger weakness in equities as they will now be driven solely by corporate earnings growth. 2018 is seeing a return of volatility and tactics trading. We are staying selective on the bond markets but we are also very cautious in the short term on the equity markets. However, we will be ready to get back into equities in the event of an excessive correction.

Armand du Pontavice, *CIO*

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