Principal Global Investors

Economic Insights: **Have the reports of inflation's death been exaggerated?**

April 2019

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Inflation isn't dead despite consensus that it is.

There is very little premium for future inflation built into long-term bond yields now. Yields on 10-year German and Japanese government bonds are near zero and the difference between two-year and 10-year U.S. treasury bond yields is less than 0.2%. Investors seem nearly unanimous that inflation and long-term interest rates will stay "lower for longer."

Will their thesis hold up? We doubt it.

But history is on their side at the moment. Inflation has stayed tame for several reasons, chief among them the lowering of trade barriers in the mid-1990s, which enabled global companies to employ hundreds of millions of low-wage workers in emerging markets and produce goods more cheaply. Importing lower-cost goods pushed overall inflation down. This outsourcing provided wage competition to developed country workers, limiting wage growth and keeping the prices of locally produced goods from rising.

More recently, the anemic recovery after the financial crisis also helped keep prices under wraps. Fears of relapse into recession brought weak demand and a rising savings rate. High unemployment and plenty of spare capacity enabled businesses to keep costs low. In addition, with demand so feeble, businesses had little ability to raise prices even if they wanted.

The tech surge has kept the lid on things for the last 20 years. Online retailers have created stiff competition and made comparison shopping easy for buyers. Replacing workers with software or robots has surely been a factor in the slow pace of wage growth in this expansion. And recent data show inflation weakness—stuck near 1% and 0.5% in the Eurozone and Japan respectively, and below target in the United States this year.

Inflation has been subdued for so long, it's no wonder investors think it will stay that way forever. But the forces for disinflation are fading. The weak demand, fear, and slow growth after the financial crisis are gone. Wage competition from emerging markets isn't as strong as in the mid-1990s. Meanwhile, wages in China have risen substantially. As a result, some Chinese manufacturers have moved to lower-cost Asian countries or even built plants in the U.S. Technology is still a disinflationary force, but robust productivity gains also support economic growth and boost demand, giving business more ability to raise prices. This year's soft inflation was likely related to last year's world economic slowdown, which seems to be ending.

Labor markets are tight and wage growth is accelerating in the U.S. as well as the United Kingdom, Europe, and Japan. As businesses regain some pricing power, those healthy wage gains will turn into moderately higher inflation. We expect the "lower for longer" consensus will slowly crumble over the next couple of years and a larger premium for future inflation will gradually creep back into long-term bond yields.

Interest rates: waiting for better growth

Long-term U.S. and German government bond yields plunged along with stocks late last year as worries about growth and recession intensified. But, long yields continued down into late March even with world stock markets in a monster rally betting that the economic slowdown was ending. Big differences of opinion happen often near the end of a long bull market. Equity investors fear missing a final melt-up of stock prices now that global growth and trade are improving. Fixed income investors seem far less assured that the growth slowdown is over, opting for the safe haven of developed country government bonds.

Yields on short-term government bonds may not stray much from current levels with policy at the Federal Reserve (Fed), the European Central Bank, and the Bank of Japan all on hold for the year. The yield outlook for long-term bonds depends on economic growth and the stock market. Another stock market downdraft would push U.S. treasury yields into the low 2% range. But if equity markets stay optimistic, and economic green shoots in the U.S. and China nurture a decent recovery from last year's slowdown, long-term interest rates could move moderately higher toward year-end. U.S. nominal growth is in the 4% to 5% range and may stay there for a while, absent a recession. That suggests long-term interest rates should head in that direction over the next two or three years.

Stock market outlook: a time of transition

Yes, U.S. stock markets have had a terrific run since the holidays. The S&P 500 index was up 3.9% in April alone and surged 17.5% through April 30 from the end of last year. In all, a massive rally. Still, last week, that index was only 2.5% above the high tick of January 2018. It's been barely more than a round trip since the low of last December. While most global equity indices have made a big move higher this year, few have hit new all-time highs.

One explanation for those range-bound markets and high volatility is that we're approaching the end of a long cycle. It's been nearly a decade of a very slow recovery from the financial crisis, persistent fear of relapse into another crisis, central bank suppression of interest rates, and very low inflation. That environment favored growth stocks with solid and steady earnings, especially U.S. growth and tech stocks as a haven in troubled times. U.S. indices were healthy outperformers that whole decade. From March 31, 2009, to December 31, 2017, the S&P 500 Index had a 17.3% annual compound return, dividends reinvested.

That long cycle of super-low interest rates and inflation may be coming to an end. In addition, the Fed is considering moving to an inflation "makeup" policy, where a decade of inflation below target might be balanced by a decade of above-target inflation. Markets may be in a kind of transition from one type of investment environment to another that is much different, where assets that outperformed in the past won't continue to do so.

Trendless markets

The best investment technique is to find a long-term trend and ride. There were plenty during the last decade. A transition, though, hints at a period without major trends. The Fed's about-face in response to December's market plunge intimates that it's mitigating the downside. Stock market downdrafts may be somewhat limited in scope. Conversely, with U.S. equity valuations back to nose-bleed levels, the upside may also be constrained. As we've been noting for over a year, good financial returns may be hard to find.

Investment implications

Despite the equity surge since the holidays, we'd stay cautious and preserve capital, as a much different investment environment may be ahead. The consistent theme of tight labor markets and accelerating wage gains will eventually feed into current inflation data, which will move up toward the Fed target later this year and perhaps a bit beyond in 2020. That will push long-term bond yields higher toward year-end as they begin to reflect a risk premium for inflation. Higher rates will be a drag on the stock market, so equity investors should stay with defensive rather than cyclical sectors. We think the low interest rate consensus will slowly fall apart as inflation and long rates work higher.

So fixed income investors would be advised to stick to short- or medium-term, high quality bonds. When the consensus finally abandons its "lower for longer" mantra, value stocks, financials, real estate, and commodity assets will be in demand.

World economic update: exiting the slowdown

First, a little background about last year's economic slowdown. The world economy began its current expansion shortly after the financial crisis. But it's been a bumpy ride, beginning with the Euro-area debt crisis and related fears about recession relapse in the U.S. Then, a crisis in emerging markets, a collapse in commodity prices, and a stock market meltdown in China curtailed global growth in 2015. Both times, China pushed its economy with various fiscal, monetary, and lending measures, which helped the global economy reflate: commodity prices rebounded; industrial activity picked up; growth accelerated in a synchronized fashion.

Last year, Chinese officials tightened lending conditions and its economy decelerated again. That was a drag on developing countries and the Eurozone as exports to China contracted. After the Fed raised interest rates, it was a year of lousy investment returns. But world stock markets put on a monster rally since the holidays as investors bet on faster growth from more Chinese stimulus and the Fed ceasing its rate hikes. Growth is now on the mend. This time, though, the reflationary impulse from China will likely be weaker. This round of stimulus is tilted toward tax cuts and may not have the same impact as surges in lending and infrastructure spending.

United States

The soft patch in U.S. activity seems to be over. Consumer confidence has rebounded after temporary weakness associated with the government shutdown and December's market gyrations. In turn, consumer spending has recovered. Core capital goods orders, a leading indicator of business investment spending, have risen nicely over the last three months. Surveys of manufacturing companies are still falling, however, but we expect a trough soon. Global growth is improving and a trade deal between the U.S. and China is likely in the works, so that softness should subside.

Looking ahead There's a lot to like about the U.S. economy: 3% growth with few signs of overheating. Accelerating wage gains may translate into a bit more inflation, but not yet. Despite faster wage growth, unit labor costs, the main way that wages feed into inflation and hit profit margins, have been decelerating. Instead, the pickup may be boosting productivity by inducing businesses to invest in productivity-enhancing equipment. Productivity growth has been trending higher and surged the last three quarters. If those gains in output-per-hour keep accelerating, the potential growth rate of the U.S. economy will rise. Potential growth is how quickly the U.S. economy can grow without inflation pressures building. The more it does, the longer the expansion can persist. We look for growth near 2.5% this year and next.

What could derail all this action? Without the typical imbalances that foreshadow a U.S. recession, the most likely culprit may be an external shock. The Fed is likely on hold well into 2020, which removes overly restrictive monetary policy as a hazard. Further trade disputes are a big risk. The new trade agreement between the U.S., Mexico, and Canada seems stalled with no vote in Congress yet. The U.S. and China may or may not come to a trade deal. Without these or other outside risks coming to fruition, the U.S. economy could sail on for several more quarters, perhaps into 2021.

Europe

The first quarter gross domestic product (GDP) report laid to rest recession fears for the Eurozone. Growth surprised to the upside, up at a 1.5% seasonally adjusted annualized rate. Hard production and output data are outperforming sentiment and survey numbers. Industrial production growth probably bottomed in December. Retail sales grew nearly 3% in February. The unemployment rate dropped to another decade low. In fact, the unemployment rate has declined 0.8 percentage points in the last year despite soft growth.

Looking ahead Stable to improving Chinese growth should feed its way into European industrial and trade activity in the coming quarters. But the benefits may not be as pronounced as in 2017. Better-than-expected growth may lessen the need for additional monetary stimulus this year.

Japan

The one major region without a rebound, Japan's industrial production unexpectedly contracted in March. Exports have been declining year-over-year since December. Still, the labor market remains the best in decades. Like Europe, Japanese exports and manufacturing should benefit from China's pickup in late 2019. Household spending growth should also recover before the next hike in the value-added tax (VAT) in October.

Looking ahead We look for 1% growth in Japan this year, but the risk is likely on the down side. If the economy begins to lag, the VAT hike will likely be postponed.

China

Taxes slashed, reserve requirement ratios cut, lending spigots on—all that stimulus seems to be working. GDP was stronger than expected in the first quarter. Key business surveys signaled expansion for a second month in a row in April and our own economic momentum indicator has been picking up.

Looking ahead We expect China's growth will be in the government's target range of near 6.5% this year. But long-term headwinds of too much debt and pollution, plus unfavorable demographics, will weigh on growth over the long term.

Other emerging markets

China's pickup should benefit its closest trading partners. But given the composition of China's stimulus, the benefits will be less tailwind than in the past. In fact, unlike 2016, raw industrial commodity prices only modestly improved from the start of the year and prices have given back some of that increase since early April. Financial conditions should still support developing country growth with the Fed on hold.

Looking ahead Developing countries may benefit broadly from the moderate rebound in global growth. But the advantages won't be shared equally.

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