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INVESTMENT MANAGEMENT

Global Multi-Asset Viewpoint

Inflation Worries Premature

SOLUTIONS & MULTI-ASSET | GLOBAL MULTI-ASSET TEAM | MACRO INSIGHT | JANUARY 2020

Well-anchored inflation has been at the heart of the 'great moderation' regime over the past roughly 30 years. Moreover, cyclically, subdued inflation this late in the economic expansion is incredibly important for the longevity of the expansion as it reduces the risk of monetary policy error and ensures fiscal and monetary policy leeway to cushion the economy if needed. But as the expansion grinds on and resource utilization tightens, at least theoretically, higher inflation should follow. Such a turn, when it happens, will be of monumental importance, and in this note we explore the possibility of U.S. inflation accelerating materially over the next 12 to 18 months. We conclude that, on this time horizon, it is premature to worry about an upturn in inflation.

During the 'great moderation,' inflation has arguably been the easiest of the macro variables to forecast in the near term. This is because inflation has remained well anchored, and any deviations from the long-term trend have tended to be lagged responses to fluctuations in real activity indicators and resource utilization measures. The lags have tended to be long enough so that, assuming historical relationships among variables held, inflation during the following year or so appeared largely predetermined. Perhaps for this reason our modelling of the core PCE deflator (we focus on this, as it is the Fed's preferred inflation measure) yields a forecast that is virtually identical with that of the consensus: a gradual acceleration from 1.6% in December of last year to 1.8% by the end of 2020 *(Display 1)*.

The overarching theme behind our (and likely the consensus's) forecasts for a very subdued core PCE is the delayed drag from the global growth slowdown over

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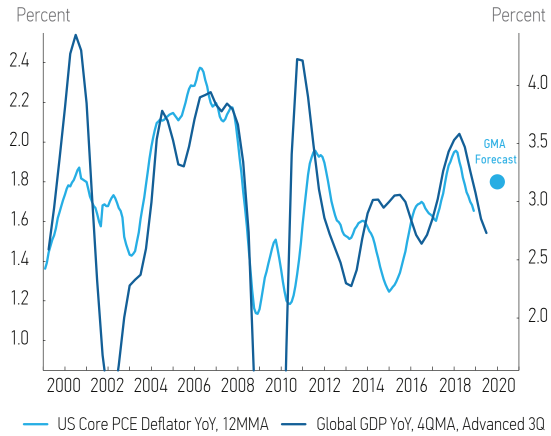
Display 1: **Global Growth Slowdown Suggests Limited Inflation Upside**

U.S. Core PCE Deflator vs. Global GDP



Source: MSIM Global Multi-Asset Team Analysis, Bloomberg, Haver, OECD. Data as of January 28, 2020. Forecasts/estimates are based on current market conditions, subject to change, and may not necessarily come to pass.

the past two years. Typically, the core PCE deflator tends to follow global growth with a lag of 18 months. It is likely that the drag will mainly come from core goods, housing, and 'other services,' which together account for over 60% of the core PCE deflator index.[1]

- Core goods (excluding pharmaceuticals) prices tend to be sensitive to global, and especially to China's, growth fluctuations and to the U.S. dollar, likely due to the import parity pricing in many goods categories. We expect the core goods component (excluding pharmaceuticals) to decelerate from a -0.7% pace at the end of 2019 to -1.25% by the end of 2020.

- Following the slowdown in housing activity in 2018 and its delayed effect on housing prices, which decelerated from +6.8% in early 2018 to +4.6% in the third quarter of 2019, we expect housing inflation to moderate very marginally.

- 'Other services' within core PCE also appear likely to decelerate, driven by a global growth slowdown, leading to a moderation in the U.S. labor market. Some slowing is already apparent in hours worked and payrolls growth, and we expect that this will continue to cause wage growth to moderate somewhat over the coming year.

Together, we expect core goods, housing, and 'other services' to detract -0.25% from core PCE by the end of 2020.

We expect the health care and financial services categories to escape the malaise in 2020 and to contribute positively, thanks to labor market tightness in the health care sector and a rebound in financial markets lifting financial services. However, their combined contribution will likely barely be sufficient to offset the drag from core goods, housing, and 'other services' described above. We also expect that the recently implemented tariffs on Chinese imports will add just over 0.12% on average through 2020 to the core PCE deflator, though this assumes 100% of tariffs are borne by the U.S. consumer, a potentially overly-pessimistic assumption.

Our relatively straightforward modelling outlined above yields a forecast of core PCE accelerating to 1.8% by the end of 2020, from 1.6% in December of 2019, basically in line with the 1.9% consensus forecast. Where could we (and consensus) be wrong *(Display 2)*?

Display 2: **U.S. Inflation to Rise Modestly From 1.6% to 1.8% by End of 2020**

Modest Upward Acceleration in Core PCE in 2020, But Still Below Target

	WEIGHT	LATEST (YOY)	2020 FORECAST BASE CASE SCENARIO
Healthcare (Services + Goods)	23%	1.6%	2.0%
Core Goods Ex-Pharma	20%	-0.7%	-1.3%
Housing	21%	3.1%	2.8%
Financial Services	9%	2.1%	3.7%
Transport Services	4%	0.4%	1.5%
Other Services	23%	2.3%	2.0%
Core PCE	100%	1.6%	1.7%
Traiff Impact			0.1%
Final Core PCE Forecast			**1.8%**

Source: MSIM Global Multi-Asset Team Analysis, Bloomberg, Haver, OECD. Data as of January 28, 2020. Forecasts/estimates are based on current market conditions, subject to change, and may not necessarily come to pass.

An obvious risk to these forecasts is that historical relationships between the variables turn out to be unstable or to become non-linear beyond certain thresholds.

First, the impact of the tight labor market may turn out to be greater than we predict as the unemployment rate falls further. Wages have tended to accelerate disproportionately when the unemployment rate approached NAIRU.[2] However, the degree of acceleration has varied from cycle to cycle and has progressively weakened over time. Even if the labor market were to turn out to be tighter—and if 'other services' inflation accelerated from +2.3% in November to an expansion high of +3% instead of decelerating to 2% as we expect—the core PCE deflator would still not exceed 2%, given the modest weight of 'other services' (23% of total). Given the recent low sensitivity of overall services inflation to unit labor costs, we estimate that it would take over 6% wage growth (assuming trend productivity growth of 0.75%) for 3% overall services inflation to materialize.

Second, with regard to health care services, a tighter labor market in the health care sector is expected to lead to an acceleration in the health care services component of core PCE. But this relationship is also subject to numerous uncertainties. Cost containment measures dictated by the Affordable Care Act have depressed prices in the sector in recent years, and our expectation is that their impact has played out. However, further policies aiming at cost containment in health care are highly likely, and this could prevent health care inflation from accelerating from 1.6% to 2% as we expect.

Third, could de-globalization prevent the disinflation in core goods that we expect and help spur higher inflation? Although we take into account the direct effect of tariffs, there is a risk that their impact will be wider and affect prices of goods in related industries, as well as tighten labor markets in affected industries beyond what we are forecasting. While we suspect that such developments may have been one of the goals of the trade war, it seems that the measures implemented so far are unlikely to have been large and broad enough for such a wide impact. After all, tariffs imposed so far amount to a relatively moderate $72 billion. Net of farm subsidies, this is just $44 billion, or 0.2% of U.S. GDP.

Another potential source of higher inflation could be an external inflationary shock. Our models do not take into account inflation trends outside the U.S. In the past, significant inflation outbreaks occurred synchronously across major economies. Although there are signs of core inflation picking up in the Eurozone and stabilizing in Japan, our global composite of core inflation is in a downward trend. Our advanced economy inflation diffusion indicator, which has historically had leading properties, suggests disinflation ahead.

Rising U.S. labor force participation is another force that our models do not explicitly incorporate, but that could continue to dampen inflation over the next several years. The labor force participation rate among prime-age males has been on a steady decline for many decades, from around 94% in 1990 to 88% at its nadir in 2015. Since then it has risen to 89% today, helped possibly by the tight labor market and the rebound in manufacturing employment since 2010, a first such episode since the late 1990s. If the prime age male participation rate were to increase to 92% in 2020, the unemployment rate would rise by 0.9%, likely forestalling any labor market overheating for the time being.

[1] We define 'other services' as services ex-energy, health care, housing, and financials.
[2] NAIRU is the non-accelerating inflation rate of unemployment, and refers to the level of unemployment below which inflation is theoretically expected to rise. The MSIM GMA team measures the NAIRU gap using the U-3 unemployment rate as implied by the U-6 unemployment rate.

Lastly, and perhaps most importantly, one has to wonder how a traditional late-cycle overheating could occur in an economy (actually in a world) where credit growth remains at or below nominal GDP growth, i.e., without a traditional credit growth cycle or major fiscal stimulus. It would seem that as the economy approaches capacity constraints, there would not be a force that generate excess demand and sustain growth in excess of its natural limits. As the labor market gets tight, instead of continued strong demand for workers leading to higher wage growth, labor demand would gradually slow to its potential, as dictated by trend labor force growth. This scenario would be unlikely to produce wage-driven inflation, as long as aggregate credit growth (private and government combined) remained at or below nominal GDP, as has been largely the case for most of the past 10 years (except for 2016-17) and remains the case today.

In the absence of the private sector's appetite to lever up, overinvest and overhire, we expect policy makers to take risk-taking upon themselves. As we have discussed in other notes, we believe policy and academic consensus around more muscular monetary and fiscal activism is emerging in the majority of major economies. However, we believe that it would take a pronounced downturn for these ideas to become policy and thus we do not expect this to matter for inflation yet. The recent outbreak of the coronavirus has the potential to depress global growth, adding to the disinflationary pressures. With the chance of policy activism in 2020 being low and risks to global growth rising, our forecast is for continued low inflation with the balance of risks to our forecasts skewed to the downside. Our expectation of below target inflation and very moderately above-trend growth this year suggests that many of the foundational characteristics and bigger trends of this expansion are likely to remain unchanged.

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CRC 2935589 Exp. 01/31/2021 9782981_CH_0220