Inflation Surprise This Spring?

By Giles D. Marshall

As the economic expansion grinds into its ninth year—already the third longest expansion since 1854[1]—perhaps the greatest conundrum for central bankers, economists and investors has been the absence of any obvious inflationary pressures. Despite quantitative easing, ongoing low to negative real interest rates, narrowing output gaps (the difference between actual and potential economic output) and tight labour markets, inflation has remained remarkably subdued.

In the United States, for example, where economic expansion is the most advanced, inflation remains below the Federal Reserve Board's (the Fed's) 2.0% target. The Core Consumer Price Index was up 1.8% year-on-year to December and the Fed's preferred measure of inflation—the Core Personal Consumption Expenditure Deflator—was up only 1.5% year-on-year. Elsewhere in the developed world, December core measures of inflation were 1.5% in Canada, 1.3% in the eurozone and 1.0% in Japan.

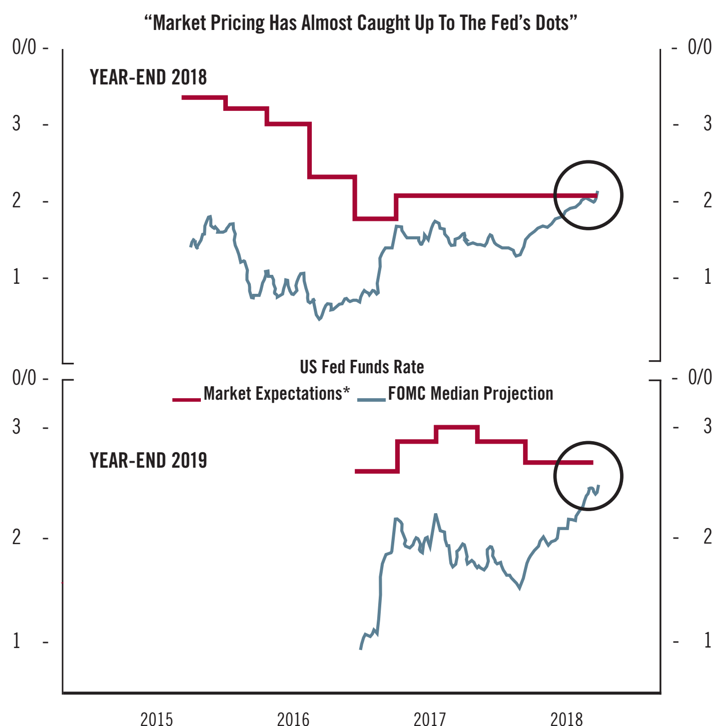
Inflation Sightings

While inflation has been elusive thus far, is it about to spring a surprise based on some of the potentially inflationary factors noted above? In the United States, inflation surprised on the upside in January with average hourly earnings rising 2.9% year-on-year, the fastest in almost a decade. It coincided with an unemployment rate of 4.1%, which is just 0.5% below what the Fed regards as full employment.

This negative surprise seems to have been the main trigger behind the rise in bond yields and equity market sell-off in late January and early February. Historically, low unemployment and inflation have been strongly correlated. We expect tight US labour market conditions, combined with late-in-the-cycle tax cuts and spending increases (that may add 0.8% to US GDP in 2018 and 1.3% in 2019[2]), to likely underpin rising inflation expectations over the coming quarters. Until now, bond investors have forecast inflation more accurately than the Fed; but at this point, the two appear aligned with three quarter-point increases in the US Fed Funds Rate, likely before year-end.

Changing inflation expectations is one of the key bond and equity market inputs we're watching and working with for 2018. We believe, given current valuations, rising bond yields will present a headwind for equity markets. Inflation may soon become part of our conversation once more.

THE US FEDERAL RESERVE BOARD AND INVESTORS' INTEREST RATE EXPECTATIONS APPEAR CLOSELY ALIGNED



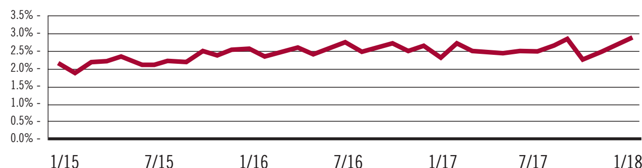
*As discounted in the overnight index swap curve. Shown smoothed except for latest data point.
Source: BCA Research, "U.S. Bond Strategy Report," March 27, 2018.

IS WAGE GROWTH ABOUT TO SURPRISE?

Exhibit 1: United States - Average Hourly Earnings

YOY Per Cent Change, Seasonally Adjusted

January 2015–January 2018



Source: FactSet, US Department of Labor, March 27, 2018.

1. "US Business Cycle Expansions and Contractions," National Bureau of Economic Research, September 15, 2014, www.nber.org/cycles.html.
2. Mark McClellan, *The Bank Credit Analyst*, BCA Research, March 2018, www.bcaresearch.com.