Investment Spotlight

ANZ Wealth Chief Investment Office

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How low inflation ends

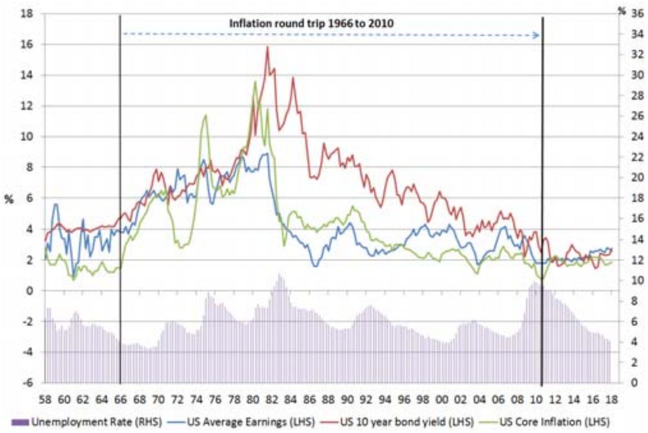
The outlook for US inflation is one of the key issues for financial markets. For the last 50 years US inflation has been on a round journey from low inflation, to high inflation and now back to stable sub 2% inflation. The end of low inflation in the 1960s provides a cautionary tale for markets. Read on for more.

A journey of a lifetime

The outlook for US inflation is one of the key issues for financial markets. It is critical for all asset classes as the trend down in US interest rates since the early 1980s has been a tailwind for valuations of all asset classes. Falling interest rates mean a lower discount rate which boosts the present value of future cash flows, raising asset valuations.

But we are not just at some standard cyclical turning point. For most of my lifetime, US inflation has been on a round journey from stable, low inflation in the 1950s and the first half of the 1960s, to high inflation and now back to stable sub 2% inflation. With the trip completed the question is what's next?

Chart 1: US inflation since 1950



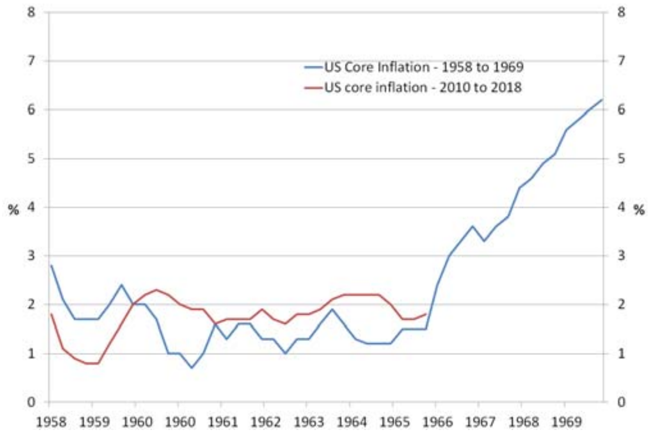
Source: Bloomberg, ANZ Wealth

History never repeats?

Chart 1 shows the pickup in inflation, wages and bond yields in the second half of the 1960s before a further rise in the 1970s and early 1980s. We see of the same parallels between now and the mid-1960s that provide some context on how a period of low inflation may end.

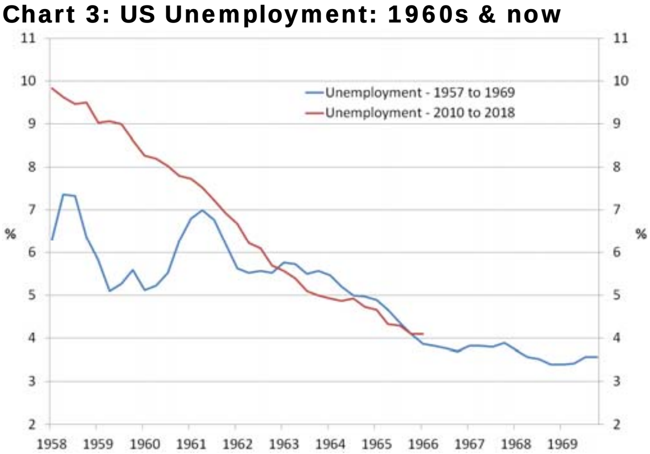
The dramatic acceleration in inflation that started in 1966 was a major trend break from the stability of the proceeding decade. Chart 2 compares core inflation (ie excluding food and energy) for 1958-1969 with the period since 2010 – the last observation in the current period aligns with the end of 1965. The reason we align these periods is the unemployment rate is close to 4% in both periods (Chart 3).

Chart 2: US inflation: 1960s & now



Source: Bloomberg, ANZ Wealth

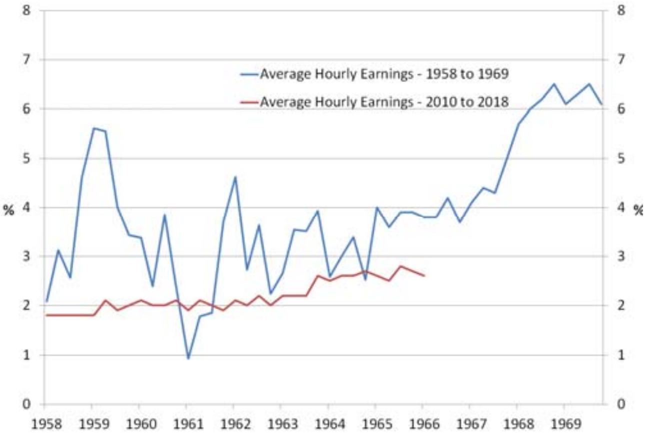
Chart 3: US Unemployment: 1960s & now



Source: Bloomberg, ANZ Wealth

The steady rise in inflation from 1½% to 6% from 1966 to 1970 coincided with sustained unemployment below 4% for over the same period. Wages growth gave the first inkling of a change as it accelerated in 1965, doubling from around 3% to 6% by the end of the decade. Currently wages are only trending up relatively slowly.

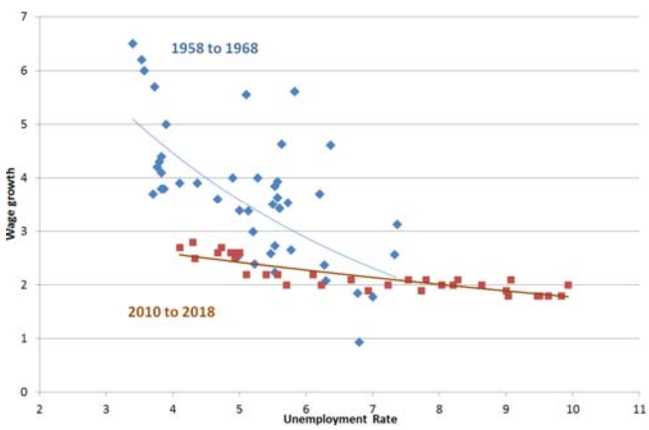
Chart 4: US wages growth: 1960s & now



Source: Bloomberg, ANZ Wealth

The much talked about Phillips curve – the relationship between the level of unemployment and wages growth - highlights a difference between the two periods so far. In the 1960s every 1% fall in the unemployment rate saw wages growth rise 1%. Now the relationship is very weak with a rise in wages of around 0.1% for the same drop in unemployment.

Chart 5: US Phillips Curve: 1960s & now

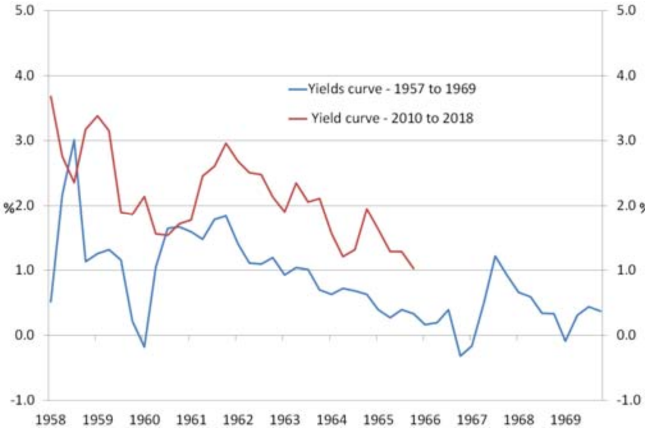


Source: Bloomberg, ANZ Wealth

A recent Reserve Bank of Australia research paper puts forward a number of factors that may explain why the post GFC relationship with wages and unemployment appears weaker.

- Wages are driven by more than just the current unemployment rate. Weaker inflation expectations, productivity (ie less ability to pay) and unionisation all combine to suppress wages.
- There is evidence that downward *nominal* wage rigidity, where employers are relatively unwilling to reduce salaries in dollar terms as opposed to real terms, combined with low inflation may result in a delayed adjustment of wages. If *real* wages (ie adjusted for inflation) need to decline due to higher unemployment, without nominal wages falling it can only happen by inflation outpacing wages, suggesting a drawn out and gradual adjustment. This suggests the flatness of the Phillips Curve may only be temporary and in time will steepen.

Chart 6: US yield curve: 1960s & now



Sources: Bloomberg, ANZ Wealth

Macroeconomic policy looks to be more supportive for growth now than in the 1960s. The yield curve (gap between cash and 10-year bond yields) has been flattening in line with the 1960s (see Chart 6). However, it is currently much steeper (100 basis points (bps) vs 30bps), suggesting monetary policy is currently more supportive of growth. Fiscal policy looks the same as in the late 1960s, with President Trump's tax cuts and increased spending adding 2% of GDP to the budget deficit, in line with President's Johnson's Vietnam War-related surge.

Conclusions

The 1960s showed that a dramatic change in trend inflation is possible, but it's no accident. An economy that is pushed too hard for too long is unlikely to ignore the laws of supply and demand indefinitely.

Sub 4% unemployment for half a decade in the 1960s set the scene for a sustained surge in inflation. While unemployment has only now just fallen to 4%, with both monetary and fiscal policy supportive of growth it is likely to move lower in the coming year. History shows that the Phillips Curve is far from stable and that the current flatness of the Phillips Curve can't be relied upon. An end of the gradual adjustment of wages due to downward nominal wage rigidity is a real risk, although the timing of this is highly uncertain.

One of the key differences this time around may be the US Federal Reserve's inflation targeting framework. Sustained low unemployment with accelerating wages and inflation is unlikely to be tolerated. However, while the rise in inflation may be more cyclical than structural, the flip side is a more aggressive change in policy to slow the economy.

Mark Rider, Chief Investment Officer

Mark is responsible for delivering an overarching investment strategy, including asset allocation, investment themes, investment manager and product selection and monitoring for ANZ Wealth in Australia. Before joining ANZ in 2013, Mark spent 15 years at UBS and 10 years at the Reserve Bank of Australia, making him a well-recognised and respected member of the Australian investment community.