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MARKET INSIGHTS

The latest Market Insights
from the Connected Wealth team

Precursor Pressures

Derek Benedet, CFP, CIM, CMT

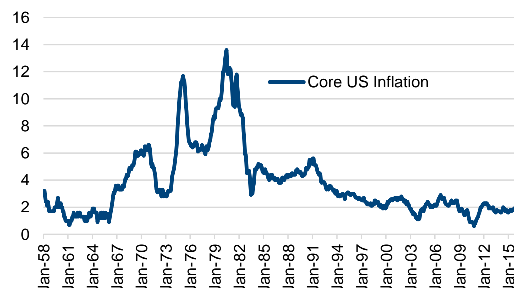
Inflation

For the past couple of years, deflationary trends were all most people would talk about when the topic of inflation came up. Whether it be subdued global growth, globalization, technology or China, there was never a shortage of reasons to believe that the multi decade trend of declining inflation would persist or even push into deflationary territory (top chart for a real long term look). Some of these deflationary factors appear to be softening or in some cases reversing. Global trade growth has slowed and there is a growing political trend against globalization. Importantly, investments that produced winning trades in a deflationary environment are not those that win if inflationary trends rise.

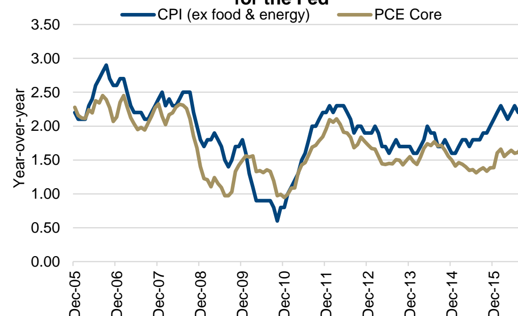
Official Consumer Price Index (CPI) numbers come in later this week, and while not high by any means, the deflationary scare of 2015 is certainly abating. In Canada, the market is expecting Core CPI to remain steady at 1.8% year-over-year (YoY). U.S. inflation data is slightly higher and excluding food and energy the market is expecting CPI to come in at 2.3% YoY. It's worth noting that much of this rise is comprised of the increasing cost of shelter. At 2.3% this is the higher end of the range last seen in 2012. In this report we'll discuss what we're observing, how we interpret it and what your portfolio implications may be.

China: Inflation has historically been more of a local phenomenon, but the world changed with economies increasingly linked. A butterfly flapping its wings in Japan might not cause a Tsunami off the California coast, but rising factory prices in China can lead to higher prices for many of the goods and services we consume regularly. Chinese Producer Price Index (PPI), rose in September, turning positive for the first time in 54 months. As you can see in the chart to the right, the trend higher turned the corner earlier this year. Worries over Chinese growth continue to abate, which removes a significant source of global disinflationary pressure from the world's second largest economy.

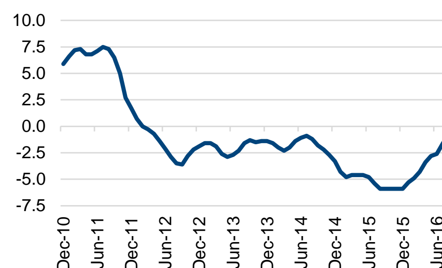
Inflation has been on the decline since 1980



Highest CPI & PCE in over 3 years - some ammo for the Fed



Chinese PPI YoY
Uptrend continues breaking 54 month negative streak



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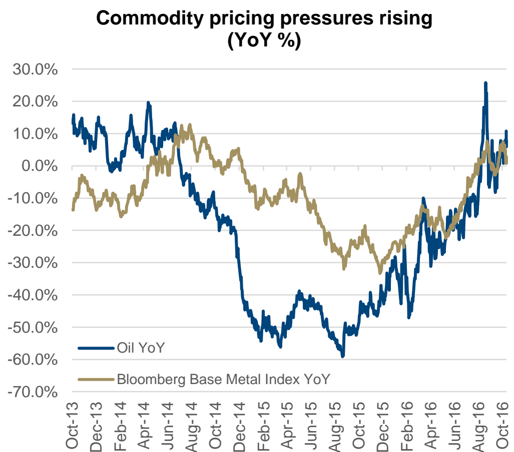
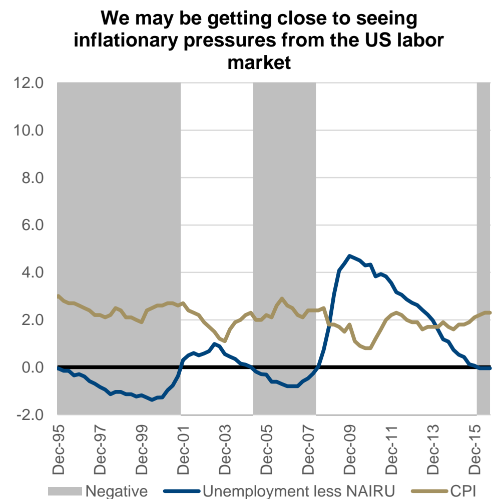
Commodities: Of course any positive economic growth aspects coming out of China has a direct impact on commodities, specifically energy and base metals. Coal imports have risen significantly this year, after multiple years of decline. This comes in line with the sharp reversal we've seen this year for most of the commodity space. To say base metals and energy prices have been on a comeback is a bit of an understatement. Year-over-year price declines troughed about a year ago. At the moment, energy and metal prices are actually positive YoY. The base effects of these moves should be a lift to headline inflation. To the right we can see the upwards trends in oil, and base metals. We'll ignore gold for now, perhaps to be revisited in a future edition.



Wage Pressure: Increasing labour constraints are likely to continue to impact inflationary pressures throughout the second half of 2016. The labour market has been tightening for some time, and while wage pressures were very slow to emerge, they are beginning to show their face. The continued growth in wages is expected to pick up as the unemployment rate continues to move lower and/or the labour market continues to tighten.

The non-accelerating inflation rate of unemployment (NAIRU) is the rate at which, if the unemployment rates falls below, inflation rises. Well, it's been negative for a couple of quarters now, and we are seeing a continued trend higher in labour costs. Both the U.S. Average Hourly Earnings and Atlanta Fed's Wage Growth Tracker are moving up and to the right.



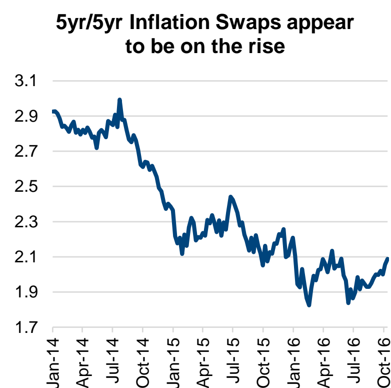
Higher labour costs, would fuel higher levels of inflation. Labour costs are a large input for companies, and it's only getting more expensive. Not just to retain high level talent, but for jobs on the lower end of the pay band such as many retail and service orientated jobs. Recently companies like Starbucks, JP Morgan and Wal-Mart have all announced increases in wages for many front-line staff from baristas, tellers, to greeters.

As slack in the U.S. labour force diminishes, the Fed has to be wary not to be stuck sitting on their hands if inflation meaningfully surpass the stated 2% longer-term targets.

Market Expectations: Five-year/five-year forward breakeven inflation expectations have historically been in a 2-3% range. This historical range decoupled post financial crisis bouncing around 1.4% and 2%. Inflation expectations have increased by 36 bps since the beginning of July. The movement in the markets expectations has deviated with the expected Fed Funds rate, with the spread hitting a new high of 128bps. Important to note that the five-year breakeven reflects not only inflation expectations, but it is a good measure of longer-term inflation expectations.

Inflationary winners: This check-up on inflationary pressures, is pre-emptive in nature. Serious inflation worries are hard to find anywhere on the horizon. There are some areas of the market that performed better than others during inflationary environments. Over time we do expect yields to rise, and see cyclical companies outperforming. Likewise, banks and insurance companies will also do well. From a fixed income standpoint, Real Return Bonds are the obvious choice and worth looking into. They have been outperforming traditional bonds in the near term, reversing a few years of lagging traditional long bonds.

These macro forces tend to move gradually at first, then pick up steam as they move along. Right now the kindling is heating up for the inflationary fire. Often if you wait for certainty, you'll miss the big market moves. We're still missing the real rise in positive economic evidence to broadly support the inflationary call, however enough signs are there in the precursors to take notice.



Inflation is just like alcoholism. The good effects come first.

– Milton Friedman

Charts are sourced to Bloomberg unless otherwise noted.

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