Fixed Income Spotlight

Global Inflation: Trend Divergence

By Andy Weir, Portfolio Manager August 2014

World economies are diverging. In the US and UK, growth momentum is accelerating and inflation is slowly creeping towards central bank targets in the backdrop of accommodative monetary policy. In the Eurozone, inflation is stubbornly low amid an unbalanced economic recovery and pessimism is priced into the market.

We discuss inflation trends across the major global markets and highlight opportunities for investment.

US: WATCH THE LABOUR MARKET

US inflation linked bonds ("linkers") have shown strong performance year to date, making up for losses incurred last year. The strong returns are partly a product of falling yields: 10 year nominal and real yields have fallen approximately 0.5% year to date. This recent performance echoes the market consensus that inflation in the US is now past its low point. 10 year US breakevens have also shown resilience this year, helped by firmer CPI releases.

Housing inflation has been a strong contributor as well as other service sectors. However, wages are by far the best indicator of consumer price gains. Higher wages allow consumers to accept price rises but wage pressures can only materialise if more people find jobs. In other words, the unemployment rate must fall in order for workers to have more bargaining power and drive up the price of labour. A measurement of the approximate level below which wage pressures start materialising is called the Non-Accelerating Inflation Rate of Unemployment, in short: "NAIRU". The chart below (Chart 1) shows that the overall unemployment rate is now 0.1% below the median estimate of NAIRU*. While this is an estimate, it does highlight the fact that unemployment has fallen sharply since the high point of 10% in October 2009. The above trend is even more evident when looking at short-term unemployment and the estimated level of short-term NAIRU. Short-term unemployment – defined as the unemployed of 27 weeks or less – is deemed to be a better indicator for wage growth as recently unemployed workers have more applicable skill sets to current jobs and are therefore the 'wage setters'. Therefore, we see scope for fundamental wage pressures to come through in the US, which will allow for consumer price increases.

Chart 1: US unemployment is now at a level where wage pressures are expected to materialise

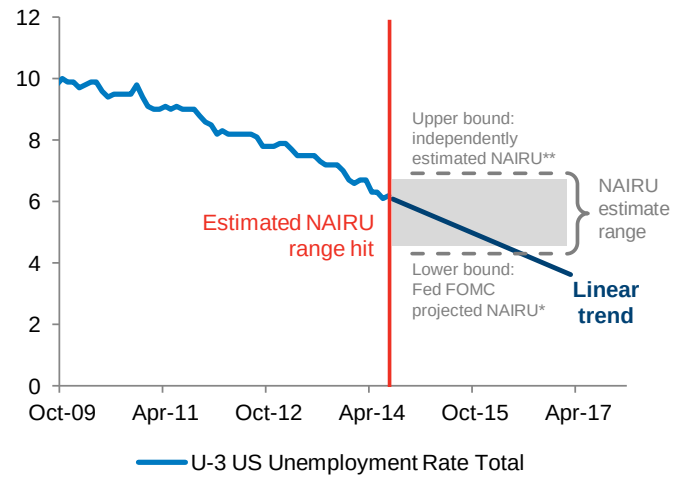
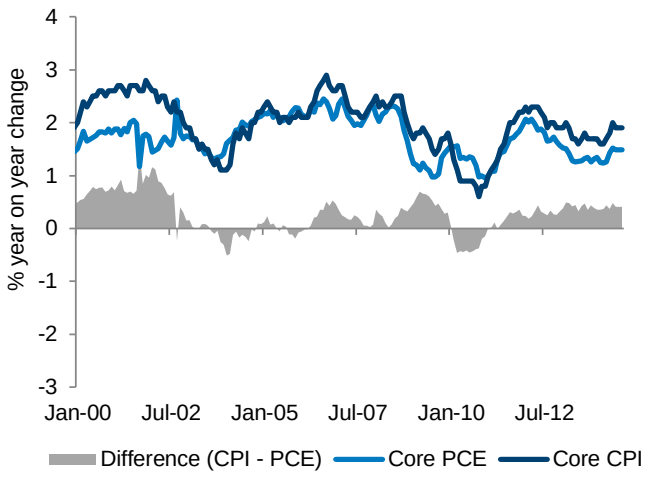


Chart 2: The Fed targets PCE but US linkers are indexed to CPI



Source: FIL Limited, Bloomberg 31 July 2014.

Today, wage inflation drives the Fed's actions. While the economy is showing signs of improvement and Q2 data was encouraging, the Fed will ultimately not hike rates unless inflation picks up – and perhaps even overshoots their target of 2% Personal Consumption Expenditure ("PCE")***. As long as wage inflation does not materialise significantly, or does not rise faster than inflation, the Fed will remain accommodative. Recent inflation numbers have been elevated for both main measures of inflation, CPI and PCE.

* NAIRU = Non-accelerating inflation rate of unemployment. An unemployment rate higher than the NAIRU indicates downward pressure on inflation, whereas an unemployment rate lower than the NAIRU indicates upward pressure on inflation. According to the FOMC, the Fed estimates NAIRU to be between 5.2% and 5.6%.

** Rate shown is the highest projected NAIRU from 7 independent studies. Projected NAIRU range between 5.9% and 7.2%.

*** PCE = Personal Consumption Expenditure. This measure is historically 0.4 to 0.5% lower than CPI (Consumer Price Index) and is the main inflation measure for the US Fed. CPI = Consumer Price Index. US Inflation Linked Bonds pay out according to this measure.

Keeping a close eye on both measures is important for US linker investors, as this is the difference between the rate of inflation targeted by the Fed and the rate that US linkers are indexed to. The Fed is targeting a 2% PCE inflation rate, whereas US linkers pay out according to CPI. CPI tends to be higher than PCE (Chart 2) and the difference is currently 0.5%. Based on history, the Fed's is target of 2% PCE translates into approximately 2.5% CPI. Thus, the combination for higher wage pressures, coupled with technical factors such as the CPI PCE gap in the backdrop of a dovish US central bank are the rationale for maintaining a positive outlook on inflation in the US.

EUROZONE: A FRAGILE RECOVERY

European CPI prints have been low and we have revised our year-end forecasts lower as well but we do not forecast deflation. Our forecast is currently at 0.6% year-on-year in December 2014 before gradually approaching 1.0% by Q2 2015. However, these levels are some way away from the ECB's 2% upper target and as long as European inflation prints disappoint or remain stubbornly low, the bank's focus will be on avoiding deflation.

There are many reasons for the low inflation rate in the Eurozone but the two key drivers are structural demand weakness and a strong Euro. The weakness in demand can in part be attributed to the comparatively high unemployment rate and the effects of austerity policies in peripheral European economies. However, the Eurozone unemployment rate has started to fall but the key question is whether the Eurozone's low growth potential is sufficient to absorb any potential rise in the supply of labour – therefore structural reforms are needed aimed at the underemployed, such as elderly workers as well as the female population.

In the near term, the ECB has pledged targeted long-term refinancing operations in order to fight further disinflation in the Euro-area – thereby recognising that the key broken link in the chain is the transmission mechanism of banks lending out money. Fully-fledged QE is unlikely in the near term because this would in the first instance be challenged by the northern European constitutional courts. We expect some form of stimulus aimed at bank lending – such as an ABS programme – before any government bond purchases. It is therefore imperative to keep a close eye on corporate lending and loan demand expectations, even though these may not always materialise.

In valuation terms, looser monetary policy by the ECB is generally supportive of breakevens over the medium to long term. The markets are pricing in very pessimistic inflation expectations, particularly in short maturities. We do believe however, that the Eurozone has the most mispriced inflation linked bond market despite a marginally lower inflation outlook in the near term. For instance, 5 year breakevens in Germany are pricing in 0.7% (adjusted for seasonality) at the time of writing which is 1.3% below the ECB's upper target limit. Therefore, breakevens can widen if inflation remains in positive territory on average over the next 5 years.

Chart 3: The Eurozone's unemployment rate has been diverging from the US and UK ...

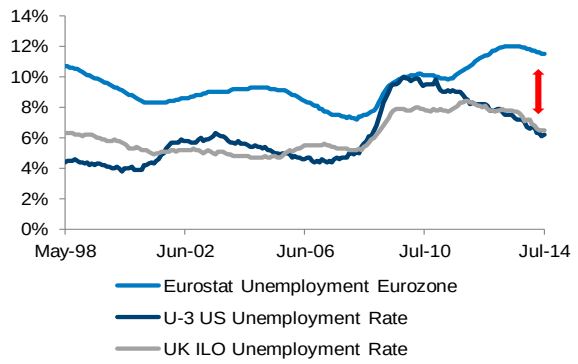
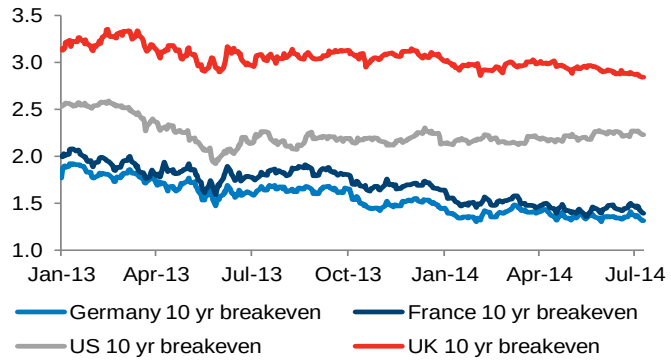


Chart 4: ... While European breakevens are pricing in pessimistic inflation expectations



Source: FIL Ltd, Bloomberg. 31 July 2014.

UK: FIRST TO HIKE?

Our forecast is for UK CPI to finish the year at 1.8% year on year. Since that level is very close to the Bank of England's target inflation rate, this raises the chances of a rate hike and we believe that the BoE will be the first developed central bank to raise rates, perhaps as soon as Q1 2015.

Recent reports have been very positive on UK employment, with hirings continuing and tentative signs of wage growth. Although higher wages allow consumers to accept higher prices, it not guaranteed that service prices will increase in order to pay for higher wages. Companies may have to absorb the labour cost increase and let profit margins decline given that margins are at a cyclical high. In addition, the unemployment rate is on a falling trend. This points to diminishing slack in the economy.

On a valuation basis, there are not many opportunities in UK breakevens. Over the medium to longer term, we could however see some upside. UK linkers are indexed to the RPI measure of inflation but the Bank of England targets CPI inflation. RPI tends to be higher than CPI by approximately 0.7% on average owing to a differing calculation methodology and differing components, including mortgage interest payments. The latter will be an increasing proportion of UK RPI if and when interest rates do rise. If this is factored into fair value expectations for 10 year breakevens, we do see potential for value over the longer term.

Chart 5: UK breakevens are generally supported ...

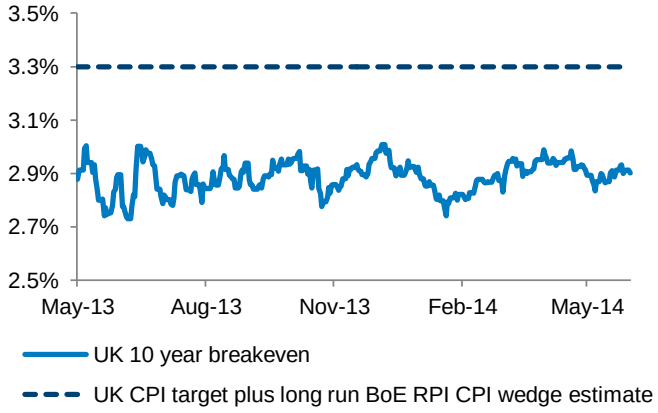
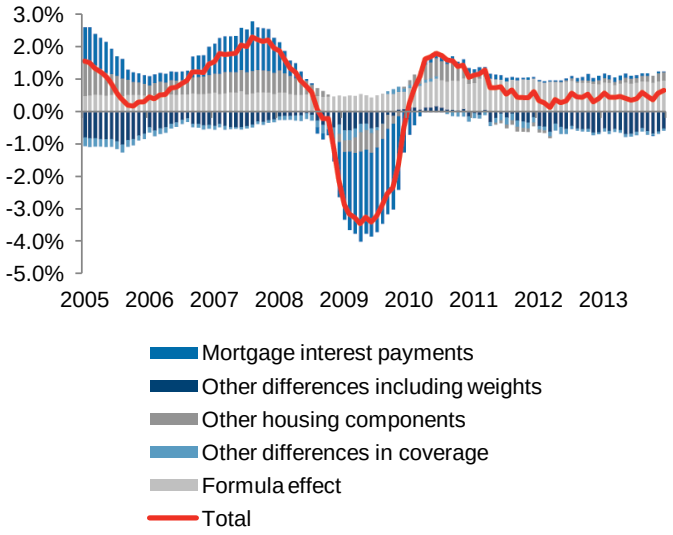


Chart 6: ... but technical factors leave potential for marginal upside over the longer term. RPI-CPI gap:



Source: Bloomberg, 31 July 2014, Bank of England Inflation Report February 2014.