



**GENERALI  
INVESTMENTS**

## Focal Point

# US inflation: A slow awakening ahead

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**Authors: Paolo Zanghieri**

- The weak response of wage and price inflation to the quick labor market tightening has sparked concerns over the state of the US economy and the prospects for monetary policy. Structural factors, first and foremost low productivity, and subdued inflation expectations are preventing a sharper and quicker rise in wages.
- Going forward, the firming of domestic demand and the solid global backdrop will provide a gradually increasing upward pressure to core inflation, over and above the unwinding of the adverse base effect. This means that US inflation should end this year around current levels (1.7%) and climb to 2.2% by Q4 2018.
- As inflation continues to undershoot the Fed 2% target, the case for rate hike in September or December has weakened. Yet amid mounting price pressures thereafter, we still expect the Fed to deliver on three further hikes in 2018.

The sluggish evolution of wage growth and inflation against a tightening labor market is a key cause for concern. Investors fear that it may slow down or even stop the process of monetary normalization undertaken by the Fed, leading to a much longer period of low interest rates. In what follows we will describe some of the key factors behind subdued wage and price growth, and outline our revised forecast for inflation, which we expect to go back to 2% no earlier than in the second quarter of 2018. Such an outlook makes another rate hike this year a close call, but remains consistent with a tighter monetary policy in 2018.

### Temporary and structural factors affect wages...

According to a broad set of indicators, the US labor market is at its tightest level since the pre-crisis cyclical peak. However this has so far failed to reverse the marked cooling in wage growth triggered by the surge in the unemployment rate between 2008 and 2010.

Several explanations have been put forward.

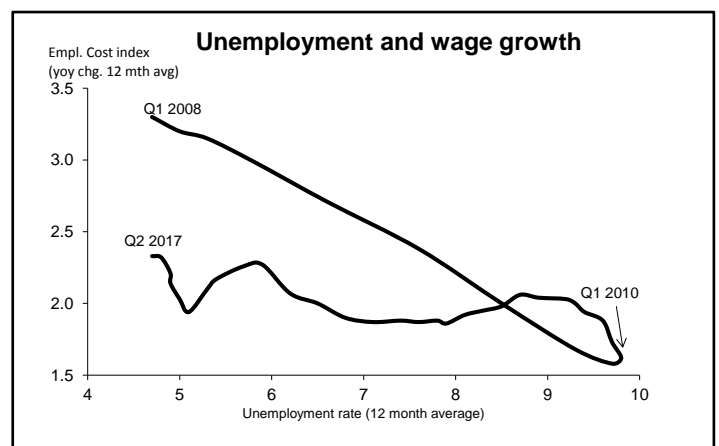
**Demographics.** A large number of older and better paid workers are retiring, being replaced by younger and lower paid ones. The crisis may have accentuated this trend, as more people chose early retirement.

**Labor market composition.** Moreover, the protracted period of growth has brought back into employment less skilled and lower paid workers.

These two facts help explain why the median wage (which adjusts for the composition for the workforce) is currently

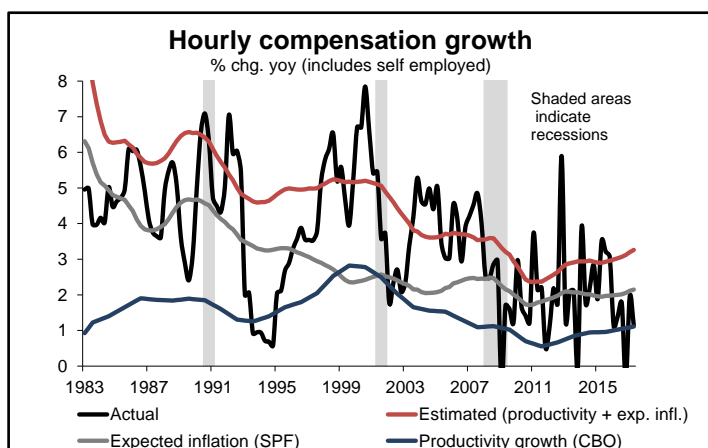
growing at 3.3% yoy, nearly one percentage point faster than average hourly earnings (2.5% yoy).

**Structural factors.** Looking for more structural explanations, it is useful to think the growth in compensation as being driven, in the long run, by the sum of labor productivity, as workers are rewarded based on their contribution to output, and expected inflation, assuming that they adjust wage demand in order to keep or increase their purchasing power.



In this sense, and as shown in the following graph, hourly compensation growth has been affected by the downward trend in productivity growth, which has been exacerbated by the fallout of the Great Financial Crisis. At the current

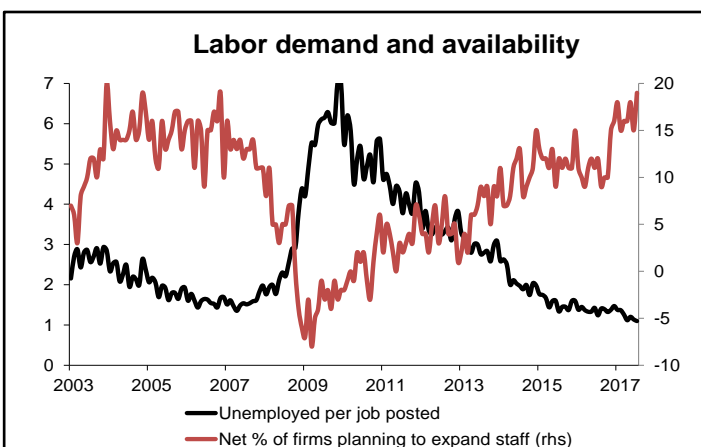
junction, subdued inflation expectations are playing a role too.



**Secular changes in the US labor market.** Workers' bargaining power has weakened over the last three decades by global competition, outsourcing and the fall in union membership. A key cause is also automation, as the number of mid-skilled workers negatively affected by it is much higher than that of high-skill ones whose wages benefit from IT skills.

**...but a tighter labor market will prevail in the end**

The strong numbers shown by the latest employment reports and the rather bullish employment outlook painted by business surveys point to a further tightening of the labor market. We do not expect a structural upswing in the participation rate and, therefore, the pool of labor will not increase significantly. Moreover, the lack of adequate skills in candidates shows up as the main concern for an increasingly high number of firms (nearly 20% of them according to the latest NFIB survey on small-medium businesses).



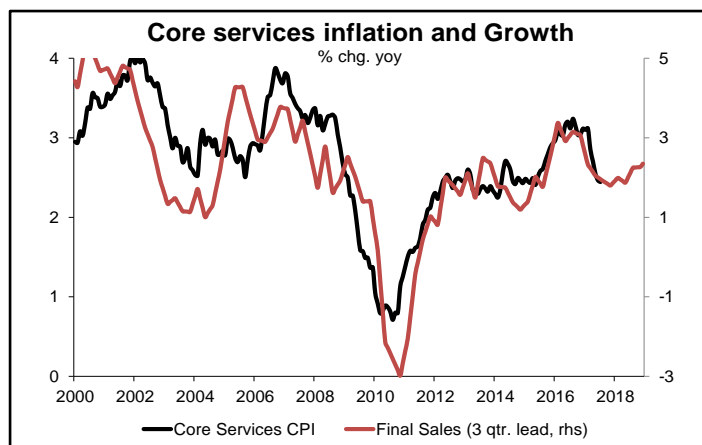
Stronger wage growth appears therefore in the pipeline, even though its size is likely to be somehow limited by the structural factors sketched above. We see the growth in the Employment Cost Index to smoothly increase from the 2.4% yoy for Q2 to no higher than 2.7%yoy over the next three to four quarters, when the unemployment rate is expected to settle at around 4%, under our assumption that real GDP continues to growth at just above 2% this year

and next. Our baseline growth outlook for 2018 hinges on the hypothesis that in the end the Congress will be able to deliver on some form of tax stimulus. Given the sharp differences within the Republican Congressional majority, we think that a compromise will eventually be reached on some tax cuts, which will stimulate the economy by no more than 0.2-0.3% of GDP in 2018. The probability of a failure to do so is admittedly increasing, given the turmoil in US politics, but even without a fiscal stimulus the economy should continue to grow at a rate consistent with unemployment decreasing somehow further.

**Core inflation to pick up no early than in H1 2018**

Slightly stronger wage growth will gradually feed through prices, especially in labor intensive sectors such as healthcare, which account for over 11% of the CPI index. We estimate that a 1pp increase in wage growth translates, after two quarters, into 0.3pp higher medical care inflation. We expect another key CPI item, shelter (accounting for 42% of the index), to continue to grow at above 3% yoy, given the ongoing strength in real estate prices and the historically low level of vacancy rates for rented and owned houses.

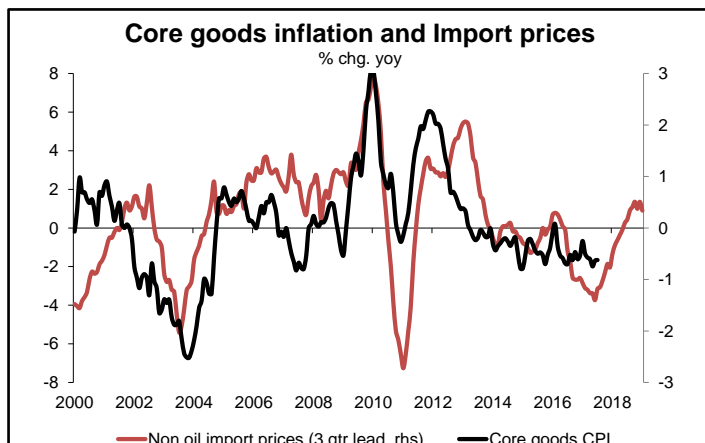
More broadly, services prices react with a substantial (around three quarters) lag to the business cycle, due to both labor cost pressures and firms only gradually adjusting prices in reaction to the evolution of domestic demand, which has firmed in the last quarters. Therefore we expect a positive contribution from the healthy growth in households' consumption seen overall in the last months (in July it was up by 3% qoq annualized in real terms).



We found, in line with other studies on US inflation, that labor market conditions play a very small role in determining the evolution of non-oil goods prices, which are very tightly connected to world manufacturing prices. The existence of long-term contracts creates lags between import and retail price, which we estimate around nine months. Therefore steady global inflation and especially its moderate increase in China, is consistent with a recovery in core good prices.

We do not expect, on the contrary, a large contribution from the 7% depreciation of the trade-weighted US dollar since the beginning of the year. Due to the long term contracts just mentioned and the fact that over 90% of US imports are invoiced in dollars, the final impact of the ex-

change rate is bound to be limited. Simulations conducted with the Fed's econometric model show that the weakening of the dollar will have a relatively small and delayed impact: at its peak in Q1 2018 it will not exceed 0.15pp.



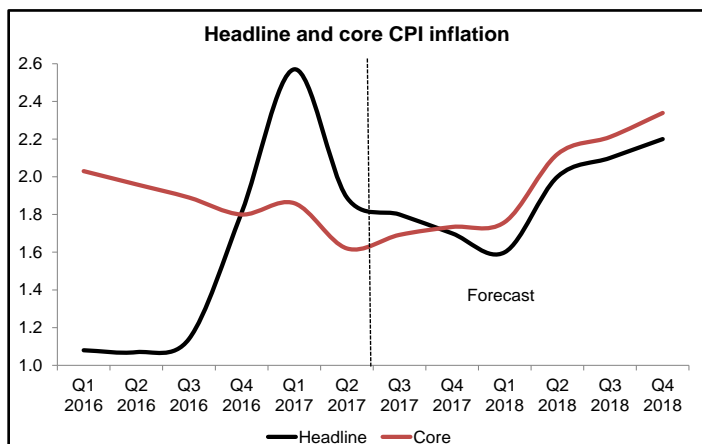
However, given the substantial lags we have documented, the different sources of price pressure described so far will play out only gradually. Therefore the outlook for inflation in the final months of 2017 remains dominated by the large one off price swings observed in Q2. The most important sector affected was been mobile phone services, which account for just 2.5% of total CPI but is experiencing prices falling by more than 13% yoy due to both a radical change in pricing by one of the biggest operator, and changes in the way the statistical office measure prices. Moreover, inflation in other items (like used cars and air fares) is weak due to market conditions in these sectors. All this is mechanically subtracting around 0.3pp to core inflation and explains why other measures of underlying inflation have weakened. We do not think that the fall in wireless prices will be followed by other sharper declines, and it would fade away from inflation calculation at the end of Q1 2018, while inflation in other sectors should at least stabilize as domestic demand is set to remain strong over the next quarters. All in all, we expect core inflation not to move much from where it is now (1.7% yoy in July) in the final part of this year and to pick up in the first half of the next year. Afterwards it will trend upwards, to 2.3% in Q4 2018.

The evolution of headline inflation will be heavily affected by the unwinding of the base effect in fuel prices seen between the end of last year and the beginning of 2017. With oil prices expected to stage only a mild recovery (the WTI should move from the current level of 48 US\$/bbl to around 51 US\$ by the end of next year), the headline rate will likely bottom up at 1.6% in the first months of 2018. Afterwards, it will edge up in line with the core rate, to 2.2% by the end of next year. Inflation will average 2% both this year and next.

### The Fed and interest rates

These strong and persistent headwinds to inflation add to the high uncertainty on US politics and on the impact of the balance sheet reduction plan (expected to be announced in September) in making further rate hikes during the remainder of the year a close call. However, the expected steepening of inflation next year appears in our view fully consistent with our call of three more hikes in

2018. By contrast, markets are currently discounting a less than 50% chance of just one more rate hike over the next 12 months. The delayed monetary policy normalization will contribute to a rather flat path for bond yields in the short term, followed by a pickup over the course of 2018.



# Imprint

<b>Head of Research</b>	Vincent Chaigneau (vincent.chaigneau@generali-invest.com)
<b>Deputy Head of Macro &amp; Market Research:</b>	Dr. Thomas Hempell, CFA (thomas.hempell@generali-invest.com)
<b>Team:</b>	Luca Colussa, CFA (luca.colussa@generali-invest.com) Radomír Jáč (radomir.jac@generali.com) Jakub Krátký (jakub.kratky@generali.com) Michele Morganti (michele.morganti@generali-invest.com) Vladimir Oleinikov, CFA (vladimir.oleinikov@generali-invest.com) Dr. Martin Pohl (martin.pohl@generali.com) Dr. Thorsten Runde (thorsten.runde@generali-invest.com) Frank Ruppel (frank.ruppel@generali-invest.com) Dr. Christoph Siepmann (christoph.siepmann@generali-invest.com) Dr. Florian Späte, CIIA (florian.spaete@generali-invest.com) Dr. Martin Wolburg, CIIA (martin.wolburg@generali-invest.com) Paolo Zanghieri (paolo.zanghieri@generali.com)

**Issued by:** Generali Investments Europe Research Department  
Cologne, Germany · Trieste, Italy  
Tunisstraße 19-23, D-50667 Cologne

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<b>In Italy:</b> Generali Investments Europe S.p.A Società di gestione del risparmio  Corso Italia, 6 20122 Milano MI, Italy	<b>In France:</b> Generali Investments Europe S.p.A Società di gestione del risparmio  2, Rue Pillet-Will 75009 Paris Cedex 09, France	<b>In Germany:</b> Generali Investments Europe S.p.A. Società di gestione del risparmio  Tunisstraße 19-23 50667 Cologne, Germany
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