

## Weekly Market Flash

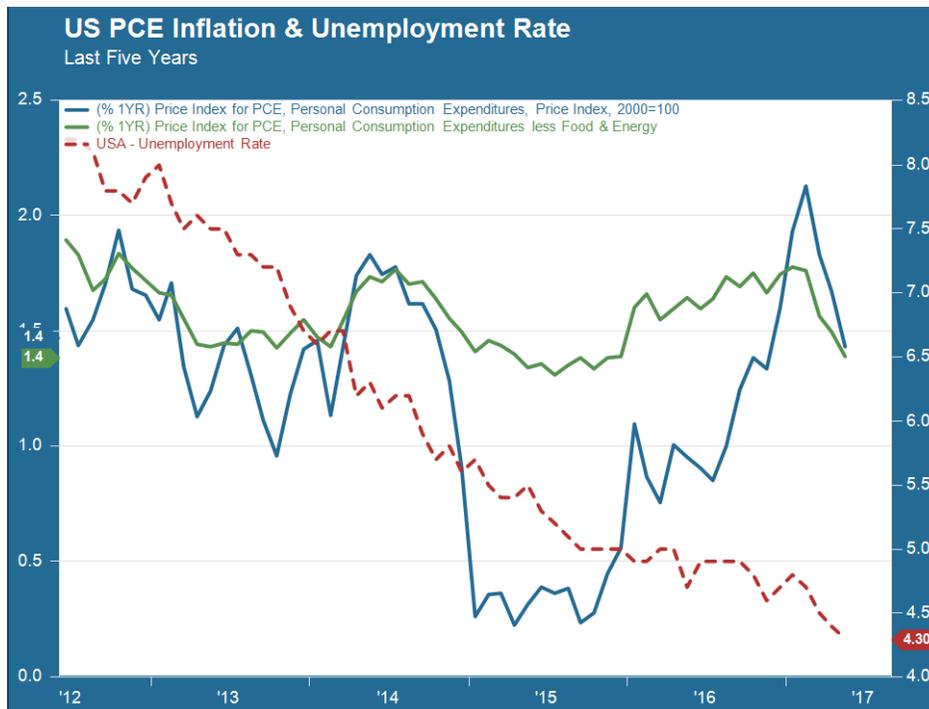
### Prices, Rates and the Lowflation Era

June 30, 2017

Investors who like nice, clean narratives keep getting flummoxed by the global economy's refusal to serve up steady sequences of consistent data points. This was a week, after all, when bond markets around the world took a Super Mario-sized beating in the wake of the ECB chairman's musings about recovery and reflation in the Eurozone. The bond carnage even spilled into the seemingly Teflon stock market on Thursday. And yet, where did it all end? In the US, the latest reading on personal consumption expenditures (PCE), the Fed's go-to inflation gauge, posted a weaker than expected year-on-year growth rate of 1.4 percent (both headline and ex-food & energy) on Friday. That same day the latest Eurozone flash CPI showed a 1.3 percent year on year gain, in line with expectations but down from the previous month. Reflation? Or could the bond market just possibly have jumped the gun a tad?

#### Phillips Curve to Nowhere

The May inflation numbers are, of course, representative of just one month. But there is very little in the longer term trend to suggest that this mythic reflation is anywhere on the horizon. The chart below shows the headline and core (ex-food & energy) PCE along with the US unemployment rate trend for the past five years.



Source: MVF Research, FactSet

The Fed pays closest attention to the core PCE rate (the green solid line) because it excludes the volatile categories of food and energy, and thus presents a steadier picture of underlying trends. As the chart shows, core PCE has fallen over the past five years from a high of 1.9 percent to the current level of 1.4 percent. Not once during this period has this rate surpassed the Fed's desired target of 2.0 percent (the headline number was briefly above 2 percent, almost entirely on account of a commensurate rise in oil prices).

While prices have largely gone nowhere over this period, the complexion of the labor market has changed considerably. The unemployment rate (red dotted line) was over 8 percent in June 2012, and currently resides at

4.3 percent. Private nonfarm payrolls have made gains every single month over this period, the longest streak since the Bureau of Labor Statistics started recording this data shortly after the end of the Second World War. Normally, economists would expect this brisk pace of labor market growth to put upward pressure on wages and consumer prices. The Phillips Curve, bane of every Econ 101 student, came into existence to quantify this relationship, but its explanatory powers would appear to have diminished to the point of irrelevance.

### Low Growth, Lowflation

When the “reflation trade” theme became the dominant market sentiment at the end of last year we expended a considerable number of words musing about just where all this growth was supposed to come from. Even the most wildly optimistic assumptions about a new bout of pro-growth fiscal policies from Washington, in our opinion, was not likely to change the basic growth equation: declining population growth, a smaller percentage of the population in the labor force and chronically low productivity together comprise a speed limit on how fast the economy can grow. If and when productivity were to return, it would quite plausibly come at the expense of jobs, as nonlinear advances in artificial intelligence and deep machine learning make real inroads into companies’ business operations. Why should we expect to see a major bout of reflation if this is the case?

This week’s bond market activity was significant. We are far from convinced that it marked the start of a paradigm shift away from the low rate environment of the past few years. The Fed may well raise rates again this year – it really, really wants to, and absent a major deviation from headline macro trends it could probably do so without too much risk of collateral damage. But unless some catalyst that we don’t see today shows up to push prices significantly higher, the urgency for the Fed to act again (or the ECB to start tapering) just won’t be there. And we are always just one unexpected market crisis away from the Greenspan-Bernanke-Yellen put coming out of the desk drawer and back into action.

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