FUNDAMENTALS

Labour market pains

In this edition of Fundamentals, LGIM Global Economist James Carrick assesses the Fed's quandary and the potential implications for global asset prices.

A tight labour market should increase the risk premium on financial assets, as the Fed could be caught between restraining inflation and limiting the burden on a squeezed corporate sector.

This time last year, financial markets were in turmoil. Commodity prices had crashed and risk assets were slumping. We argued that while US domestic demand should prove resilient, the Federal Reserve should act cautiously to prevent a self-reinforcing credit crunch. Not only did the Fed postpone raising interest rates again until the end of the year, but the European Central Bank, the Bank of Japan and the Bank of England all expanded their quantitative easing programmes to buy more government and corporate bonds.

These interventions appear to have worked. Risk assets have rallied and credit conditions have eased. This, in turn, has boosted our lead indicator for growth over the next year. While the general consensus is that US growth should hold up well in 2017, there is a greater divergence of opinion about the inflation outlook. In particular, although it is widely acknowledged that 'headline' inflation is likely to rise in line with the recovery in commodity prices, many believe that 'core' inflation (ex food and energy) pressures remain weak.

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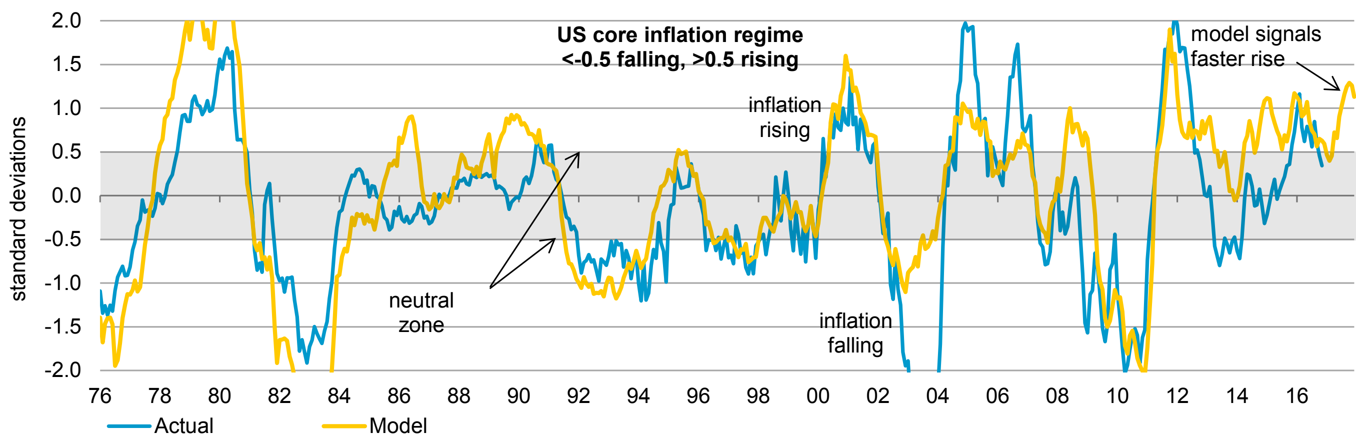
Figure 1. Our inflation regime model points to rising US core inflation



Source: Macrobond, LGIM estimates

SECOND ROUND EFFECTS FADING

By contrast, our models suggest that core consumer prices and wages will accelerate during 2017 **(Figure 1).** This stems from the fading of so-called 'second round' effects from the previous collapse in commodity prices.

What do we mean by this? When the price of oil falls sharply, we usually see a corresponding decline in petrol prices within a month. This is an initial or 'first round' effect of cheaper commodities on consumer prices. Second-round effects are those which occur later, as lower costs trickle down the pipeline. Lower energy prices eventually depress airfares which in turn can subdue package holiday prices. Lower transport costs can also reduce food prices, which in turn can temper restaurant prices. Similarly, lower steel prices can put downward pressure on car prices. As airfares, holidays, restaurants and cars are all part of 'core inflation', you can see how sharp moves in commodity prices can eventually affect core inflation.

ARE WAGES ABOUT TO RISE?

There is, however, another and arguably larger channel through which commodity prices can affect core inflation – via wages. Our analysis finds the biggest driver of wage inflation is the tightness of the labour market, as measured by unfilled job vacancies. But we also find a significant role for lagged changes in consumer prices. A sharp fall in headline inflation allows employers to get away with a modest pay increase, because their workers still feel happy as their living standards are rising. By contrast, workers are more likely to resist a modest pay increase when headline inflation is rising rapidly as their living standards would be stagnant or declining.

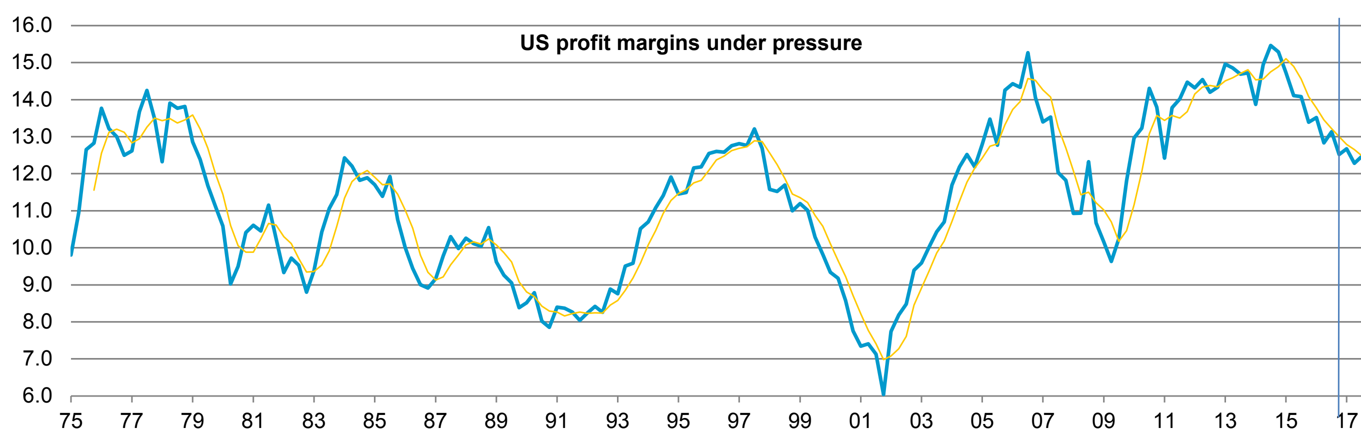
So as lower commodity prices pushed US inflation towards zero in 2015, this should have dampened wage inflation, particularly as some wage contracts have backward-looking cost-of-living-adjustments (COLA) built in. In turn, this would have subdued service-sector inflation where wages are the biggest component. But with higher commodity prices pushing headline inflation back to 2%, we believe this will have knock-on effects on wages and therefore service-sector prices over the next year, particularly given the number of unfilled job vacancies remains extremely high, suggesting excess demand for labour.

A rise in wages is good for consumption and therefore supportive for corporate revenue growth. But it also poses some offsetting problems for risky assets: a margin squeeze, higher risk-free rates and increased volatility.

THE PRICE OF HIGHER INTEREST RATES

US domestic profit margins appear to have peaked in 2014 and our analysis suggests this squeeze will continue as the tight labour market and strong dollar offset better growth and higher commodity prices **(Figure 2).** In aggregate, we see nominal domestic profits being broadly flat. For a given multiple, this would depress risk-asset valuations. Of course, some stocks, sectors and market indices will be more sensitive to the rally in commodity prices than the increase in labour costs, but

Figure 2. US profit margins peaked in 2014 and remain under pressure



Source: Macrobond, LGIM estimates

on a whole-economy basis, we expect margins to come under pressure.

Higher risk free rates could put downward pressure on the valuation multiple investors are prepared to pay. Rising wages and core inflation should encourage the Fed to keep normalising interest rates. As the yield on 'risk-free' assets such as cash and government bonds increases, the premium investors require to hold more illiquid and riskier assets such as corporate bonds, property and equities should rise.

Lastly, the risk premium could also increase as the world becomes more volatile. In recent years, central banks have been able to respond to various geopolitical and financial shocks by keeping monetary policy loose. This is because inflation has been below target and they were therefore able to keep their foot on the accelerator. But as inflation approaches its target, policymakers will have less flexibility. Of course, they can react to a big shock (which is likely to be painful anyhow), but can they micromanage smaller shocks as nimbly as in the past?

ARE WE NEAR THE END OF THE CYCLE?

Looking further ahead, these factors (a margin squeeze, higher risk-free rates and increased risk premiums) suggest we're getting closer to the end of the current economic expansion. The credit and economic cycles are closely interlinked (see the previous edition of Fundamentals: "Yellow Card", June 2016). In particular, every recession in the past 50 years has been preceded by banks making it more difficult for their customers to get a loan (a tightening of credit conditions). If you can predict when the credit cycle will turn, then we believe you can predict when the next recession will come.

WHY BANKS ARE LIKE HEDGEHOGS

Our analysis views banks as being like hedgehogs. They are cute and cuddly in the good times, but can quickly curl up into a prickly ball when threatened. We find they react according to the performance of previously-made loans. When banks' existing customers are able to service their debts, banks are happy for new and existing customers to borrow more money, perhaps excessively so. But if delinquencies pick up (when loans become overdue by 30 days), banks react by shutting up shop and refusing to extend credit to new customers or rollover existing loans. In turn, this triggers a recession.

So the key to predicting banks' behaviour – cute and cuddly or curled up and prickly – is to assess the outlook for overdue loans. There are three factors at play – the amount of debt, interest rates and the amount of income to service those debts. At present, corporate debt growth is rising by around 6% year on year, which is faster than the long-run nominal growth potential of the US economy consistent with the Fed's inflation target. The Fed has started to raise interest rates and we see further tightening to come as core consumer prices and wages accelerate. Risk premiums charged on corporate loans could rise even further. And whole-economy corporate profits are being squeezed by a tight labour market.

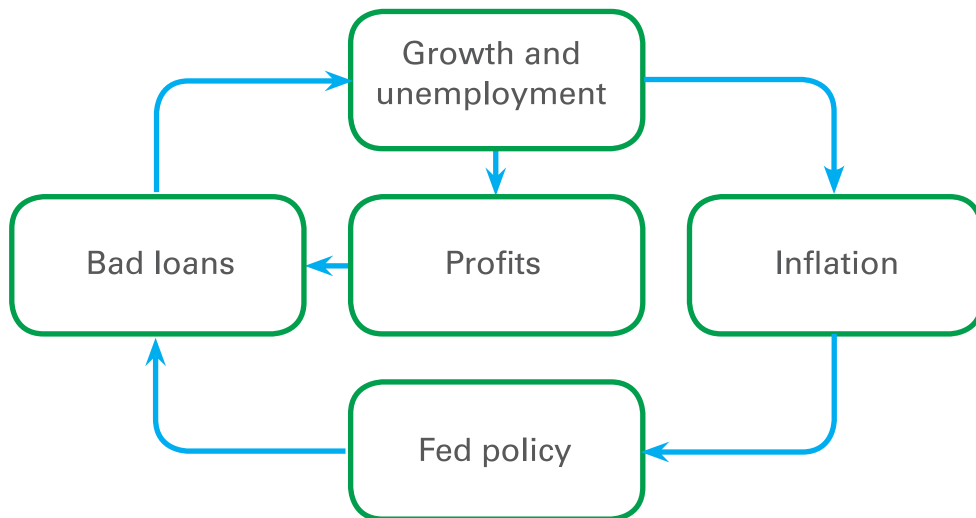
HOW LONG WILL THE GOOD TIMES LAST?

While credit conditions are currently benign, we're unsure how long the good times will last. Loose

monetary policy over the past year has pushed down market interest rates and this should support economic growth in 2017. However, if we're right that the tightness of the labour market has been masked by second-round effects from lower commodity prices, then wages and core consumer prices should accelerate in 2017. The Fed is therefore likely to continue to hike interest rates. On top of this, market risk premiums could increase too. With profits also being squeezed by a tight labour market, we see some upward pressure on the number of 30-days overdue corporate bad loans. In turn, this could cause a self-reinforcing tightening of credit conditions.

The big picture is that in contrast to previous years, the Fed has more than one fire to fight **(Figure 3)**. If it keeps interest rates too low for too long, it risks inflation taking off. If it tightens too quickly, it could undermine corporate finances. So while economic growth is expected to hold up well over the next 12 months, investors with a longer-term investment horizon might want to be cautious as we approach a different stage of the economic cycle.

Figure 3 – Rising inflation means the Fed can no longer respond to any shock to profits



Source: Macrobond, LGIM estimates

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