Inflation Series Part 6: applying the inflation assessment framework and generating an inflation outlook

Introduction

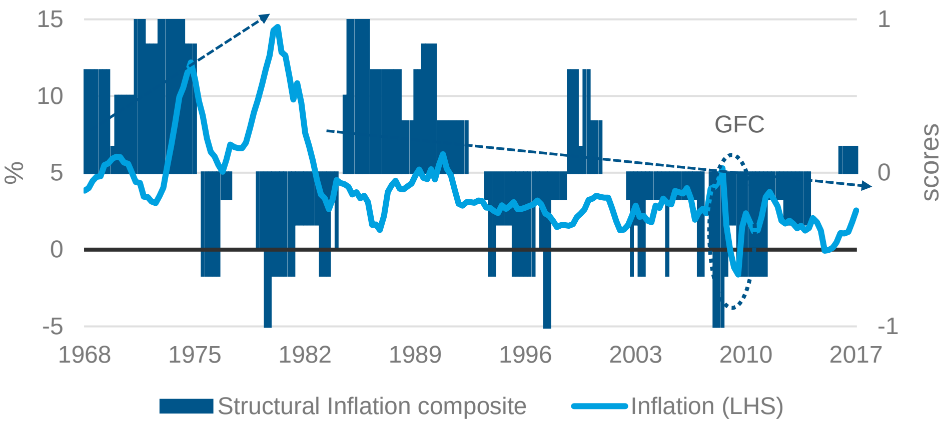
We have now arrived at the 6th and final instalment of our series on assessing inflation. The journey began at the basics, where we revisited the question of what fundamentally causes inflation. We then proposed the idea of demarcating inflation into structural and cyclical segments as a more effective approach of analysis. This is because knowing whether a particular inflation trend is structural or cyclical is very useful. As a result, we suggested two sets of indicators – one for structural and one for cyclical – that we believe ought to be focused on when assessing an inflationary trend. The stage is now set to apply the proposed framework and show how it works in practice. In particular we will use it to assess the near to medium term outlook for inflation, which we view as a critical building block for developing an effective investment strategy. In addition, as stated in Part 1, the analysis here may provide further insight on the progress made on the road back to 'normal'.

The inflation assessment scorecard

Structural and cyclical inflation indicators should form part of an inflation assessment scorecard, which itself should be placed within a broader strategy framework. In Parts 3 and 4, we suggested the selected indicators be combined into composite scores, one for structural and another for cyclical inflation, to be used as a signal of the extent and direction of inflation. At the same time we should be aware of how the individual constituents of the composite scores are moving. This will enable more insightful analysis. For example if the composite structural inflation score implies a strongly rising trend, it would be helpful to know if it is the demand or supply side indicators (or both) that are driving the score – for example, if it is predominantly supply side driven then we can expect the prevailing trend to persist for longer.

The structural inflation signal

Chart 6a. The structural inflation signal and inflation



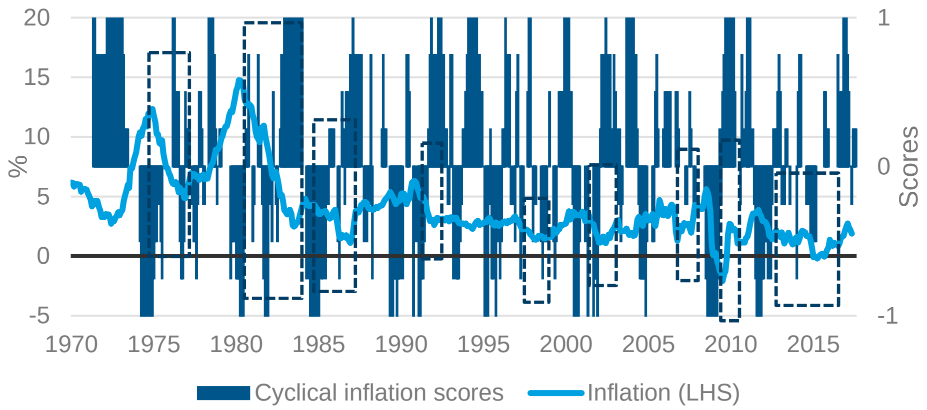
Source: Thomson Reuters, Macquarie, June 2017

The structural inflation signal, shown in Chart 6a, would have alerted markets of the significant rising structural trend that begun in the late 1960s fairly well. The subsequent structural decline from the late 1970s was signalled fairly well also. More recently the disinflation after the GFC is not only flagged as structural but seems to have its roots before the crisis according to our structural indicator. Finally note that the structural indicator was calling for an increase in structural inflation around the mid-1980s into the early 1990s. However the inflation trend did not quite rise as implied. This was because the structural forces raising inflation – significant trend decline in capital expenditure growth and slowing productivity recovery in the face of buoyant consumption – were quickly reversed in the mid-1990s due to the decade long technology boom that ended as the 'Tech Crash'.

The cyclical inflation signal

While it is always challenging to ascertain a cyclical episode, there have been sufficient episodes of inflation moving in line with the business cycle to test how our cyclical inflation signal performs. Chart 6b below shows the major transitory upward and downward inflation phases that have been indicated – we have highlighted the major falling inflation phases for emphasis. In particular, the two transitory cyclical inflation phases during the rising structural inflation trend of the 1970s were fairly well signalled.

Chart 6b. The cyclical inflation signal and inflation

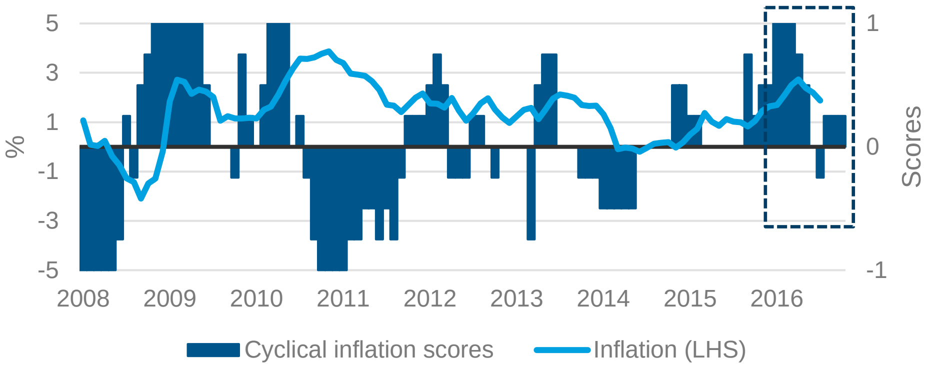


Source: Thomson Reuters, Macquarie,June 2017

The outlook for inflation

In the shorter term, anything up to 12 months, cyclical inflation could be on the uptick (see Chart 6c). However the more recent scores recorded suggest that higher inflation rates are unlikely to accelerate to levels that will worry the US Federal Reserve. Upon further analysis of the constituents of cyclical inflation, we found that the rising commodity prices indicator is the key driver although other cyclical components are 'catching up'[1].

Chart 6c. Cyclical inflation on the rise



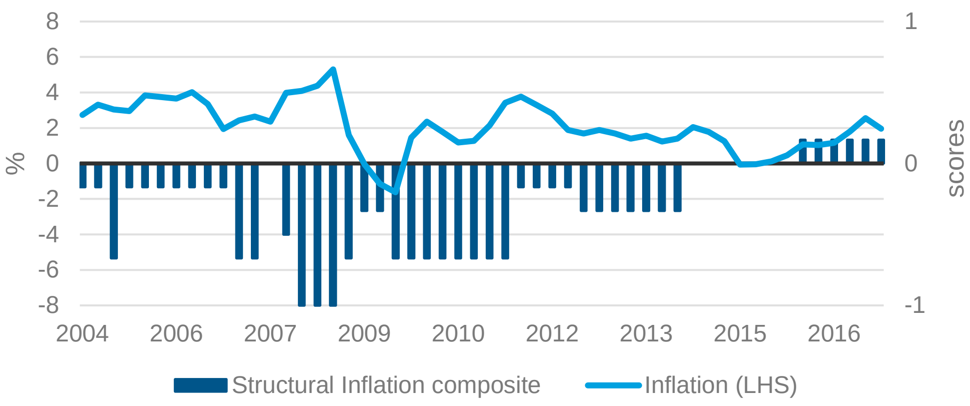
Source: Thomson Reuters, Macquarie,June 2017

Beyond the next 12 months, our structural signal continues to imply that long term inflation is reasonably contained (see Chart 6d below). The recent run of positive but fairly low scores might suggest the need to keep an eye on structural indicators but we believe it is nothing to raise any alarm bells, if history is any guide. However, when we delve deeper into the constituent drivers of structural inflation, we get a more interesting insight (see Chart 6e below).

1 The evidence is available upon request.

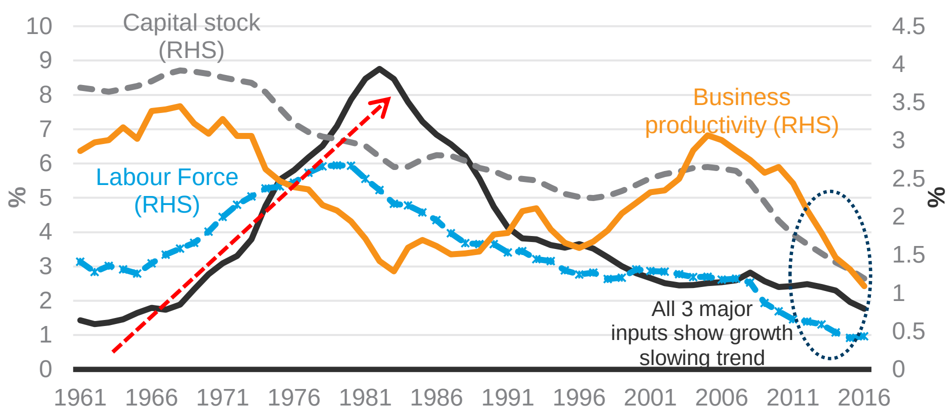
Recent supply side indicators are implying that structural inflation could be a possibility. Especially if we take into account demographic patterns such as the aging labour force.

Chart 6d. Structural inflation contained for now



Source: Thomson Reuters, Macquarie,June 2017

Chart 6e. Supply indicators implying structural inflation



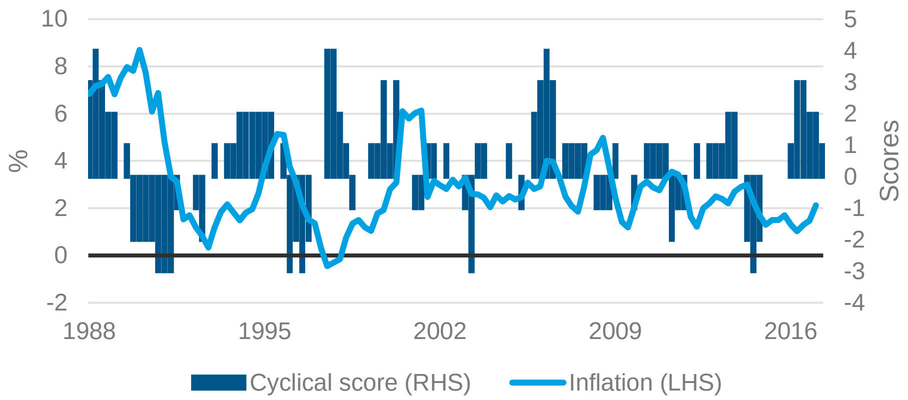
Source: Thomson Reuters, Macquarie,June 2017

So why haven't we seen more structural inflation pressures? Firstly supply side effects are traditionally slower to impact, although once realised, they are harder to reverse. Secondly and more importantly, structural demand side forces are still exerting a significant restraining effect and have thus far kept the structural balance between demand and supply fairly settled. But unless capital expenditure or productivity growth improvements emerge soon, watch this space for structural indicators of inflation to start flashing.

Structural and cyclical indicators: the case of inflation in Australia

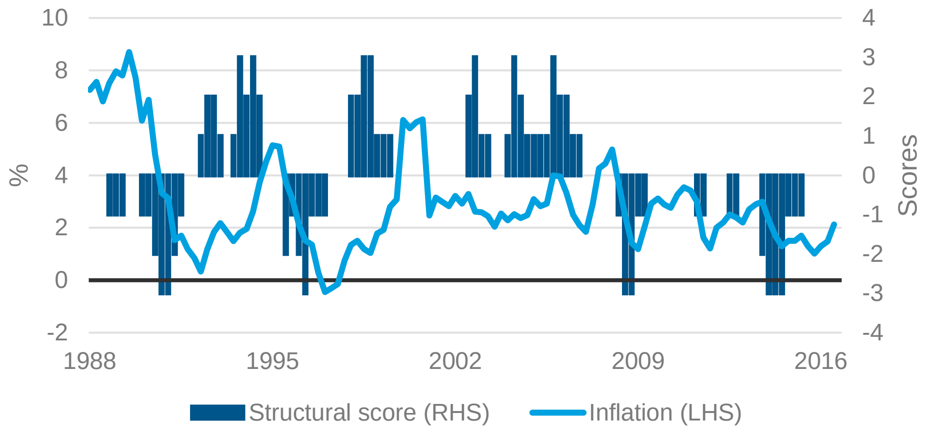
For completeness, this section showcases our structural cyclical framework for assessing inflation in the Australian context. The message from charts 6f-6g is only slightly different from that of the US. While cyclical inflation appears to be rising like in the US, structural inflation in Australia continues to be well contained.

Chart 6f. The cyclical inflation signal: Australia



Source: Thomson Reuters, Macquarie,June 2017

Chart 6g. The structural inflation signal: Australia



Source: Thomson Reuters, Macquarie,June 2017

Final thoughts and conclusion

We have travelled a fair way in our inflation series. While we will not attempt to summarise the findings of the entire series here, we would like to emphasise a couple of points. The most important, in our view, is that, if there is just one thing to be taken away after reading all 6 parts, it is that inflation (or disinflation) is fundamentally the result of net demand imbalances. Any analysis should begin by asking how a particular change is impacting this relationship between demand and supply. In addition we believe it is useful to think about inflation from the perspective of whether it is moving on a structural or cyclical trend. We have also proposed some indicators – both structural and cyclical -that we believe to be especially effective in guiding investors on assessing inflation. In closing, we want to highlight the result that currently our cyclical inflation indicators are implying inflation could rise significantly within the next 12 months. While our structural inflation indicators are implying long term or structural inflation remains contained, they should still be put on the watch list.

Lastly, what do these results tell investors about the journey back to 'normal' conditions? If the return of inflation alone, both structural and cyclical, is to be the cue, then reasonable progress to normality might be presumed. However given the manner that structural inflation is threatening to emerge, that is, on the back of structural supply side forces, with unprecedented demographic effects intensifying, it is just as likely that the road back to normality took an unnoticed fork some time back. The 'normal' that investors are looking at today might look familiar from an inflation perspective but might not be the case when viewed from a broader macroeconomic perspective.

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Americas
Market Street, Philadelphia
T: 215 255 1200
E: mim.americas@macquarie.com

Asia
Harbor View, Hong Kong
T: 852 3922 1256
E: macquarie.funds.hk@macquarie.com

Australia
Martin Place, Sydney
T: 1800 814523
E: mim@macquarie.com

Europe/Middle East/Africa
Ropemaker Place, London
T: 44 020 3037 2049
E: mim.emea@macquarie.com

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