

# ► STRUCTURAL DECLINE OF INFLATION OFFERS GOOD CLIMATE FOR EQUITY INVESTMENT

The year 2017 has been a year of strong global growth. The breadth of PMIs (Purchasing Manager Indices) above 50 stands high at 90%<sup>1</sup> and the global economy is seeing its most synchronous growth for the past 50 years<sup>2</sup>. Yet as central bankers look to their Phillips curves and econometric models, they are confronted with a perplexing problem: inflation is still below target. Indeed, over the past 20 years, barring the occasional cyclical uptick, inflation has been on a downward structural decline (Fig.1).

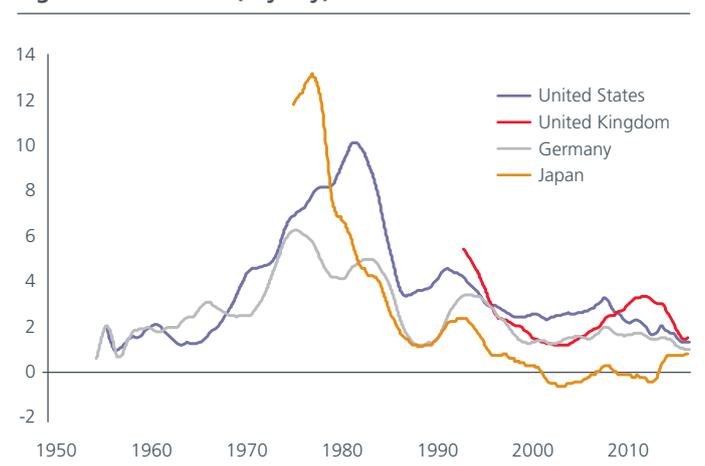
As investors, we are more concerned about how inflation will move in the future than in the past and its implications for our investment strategy. Do we expect inflation to continue its slumber or come roaring back to life? Any argument of reversion to “normality”, anchored on expectations of higher inflation levels that were present during the 1990s and 2000s, lacks merit. Current levels of inflation existed during the 1950s and 1960s in the United States and Germany and are therefore no anomaly. Rather, any viable argument for higher inflation rates will have to be founded on how the structural factors that have contributed to declining inflation namely globalisation, demographic changes and technological advances will change. We posit that



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little will change in the short-term and that these factors will continue to place downward pressure on inflation. In an environment characterised by low inflation and decent growth, we remain more positive on equities relative to bonds.

**Fig.1: Inflation rate (%y-o-y)**



## GLOBALISATION: TOO LATE TO UNWIND THE CLOCK?

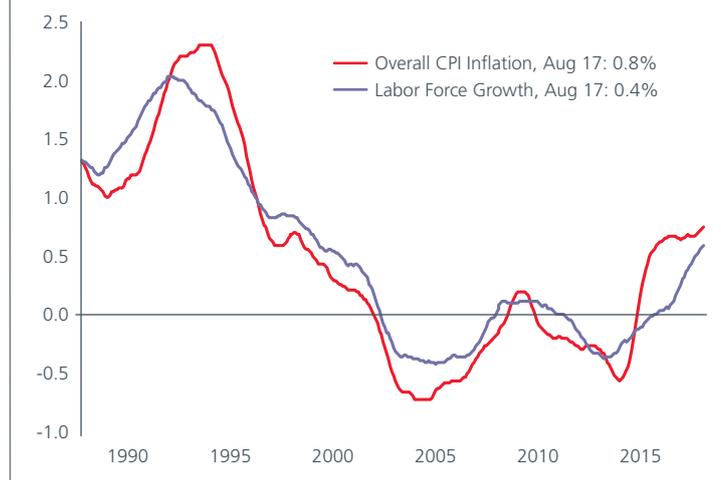
The rise of global value chains (GVCs) has enabled multinational corporations (MNCs) to arbitrage inputs of production and regulations across different countries. This ability has allowed MNCs to move production from a country where there is over-demand for production inputs (e.g. labor) to another where economic slack is present (e.g. emerging markets)<sup>3</sup> while still maintaining access to domestic markets. Wages within a country are therefore not only influenced by domestic conditions, but also by conditions elsewhere in the world. This reduces the bargaining power of labor relative to capital, leading to a decline in the labor share of income. Since the propensity to spend out of labor compensation is higher, a declining slice of the pie will place constraints on consumption demand<sup>4</sup> and hence help maintain low inflation.

Is there perhaps any risk of “deglobalisation”? Although Brexit and the election of President Trump were heralded as a counterattack for those “left behind”, no real meaningful policies have emerged to suggest any scaling back of globalisation. The UK government seems to be in disarray, while the Trump administration has yet to produce its first major legislation in a Republican-led House and Senate. The Trans-Pacific Partnership (TPP) continues without the United States and populist movements in France and Austria have come and gone. Although it would be folly to discount entirely the risk of “deglobalisation”, nothing currently seems to suggest that it will occur near-term.

## DEMOGRAPHICS: THE CLOCK IS TICKING

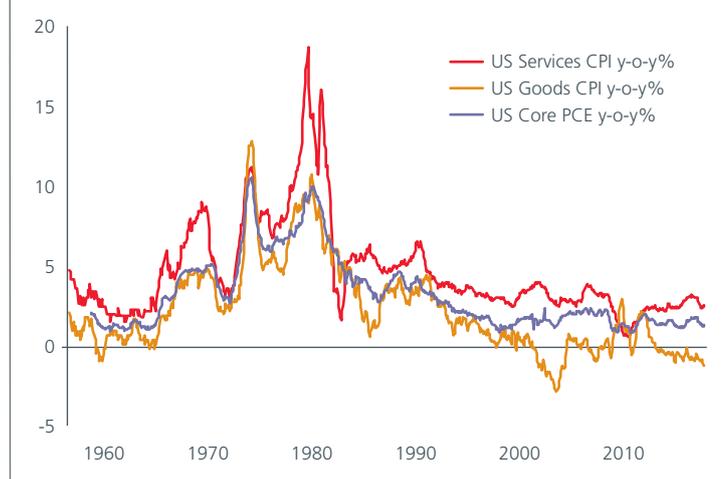
Many countries are experiencing or are set to experience a declining and aging population. These demographic changes could affect inflation through the lowering of productivity and aggregate demand. An interesting case study of such a

**Fig.2: Japan CPI inflation vs labor force growth (%y-o-y)**



phenomenon is Japan, a country at the frontier of demographic changes. Although it is a stretch to claim causality, the period of declining inflation in Japan has coincided with a period of slowing labor force growth (Fig.2). A recent report by the IMF also concluded that the aging and slowing population expansion in Japan have contributed to deflationary pressures.<sup>5</sup> Japan could be a cautionary tale for what is set to come in other countries.

**Fig.3: US Inflation (Services, Goods, PCE)**



## TECHNOLOGY: CLOCKING IN PRODUCTIVITY GAINS

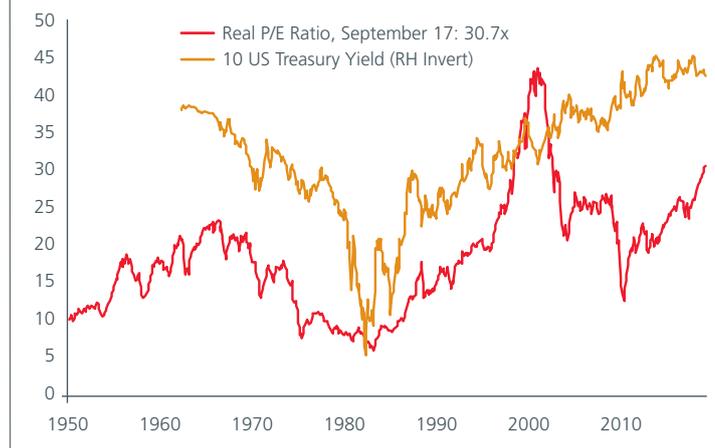
As technology advances, productivity of the economy increases, allowing it to grow at a lower cost than before. This places a lid on the inflationary pressures that usually accompany a growing economy. Manufacturing has perhaps been the sector most affected by technological change throughout recent history. As more efficient machines were introduced, factories were able to crank out larger volumes of goods at diminishing costs. In the United States for example, these effects can perhaps be best seen in the disinflation of goods (Fig.3).

Going forward, advances in technology like artificial intelligence will soon spread disinflationary pressure to the services sector. For examples, medical diagnosis can easily be done through healthcare apps without having to see a doctor. Driverless cars cut out the additional cost of a human driver. While these technologies are hardly perfect now, it is undoubtedly the direction that the economy is heading.

## WHAT NEXT FOR THE MARKETS?

With low inflation expectations, bond yields could remain low for a while longer. The bond market does not seem worried about any cyclical upside surprise in inflation, perhaps with an

**Fig.4: S&P 500 Shiller**



assumption that inflation can be easily combatted by monetary policy tightening. We therefore expect bonds to deliver weak returns relative to equities going forward.

If yields and inflation stay low, it is possible that equities will continue to command higher valuations relative to history due to the decline in the discount rate (Fig.4). In a macroeconomic environment characterised by low inflation and decent growth, we could be repeating the golden eras of the past (such as the 1950s and 1960s) where we saw equities deliver strong performance. At the very least, with the lack of any alarm bells, we expect the Goldilocks "Just Right" situation for equities investment to persist for longer.

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Sources: <sup>1</sup>Ned Davis Research Group, The Autumn Global Macro Outlook. <sup>2</sup>WSJ's The Daily Shot, U.S. Prime-age Population has not Increased in a Decade. <sup>3</sup>BIS, The Globalisation of Inflation: the Growing Importance of Global Value Chains. <sup>4</sup>OECD, The Labor Share in G20 Economies. <sup>5</sup>IMF, The Impacts of Demographics on Productivity and Inflation in Japan. Fig.1. Thomson Reuters Datastream, as at November 2017. Y-o-y = Year on year. Fig.2. Thomson Reuters Datastream, as at 2 October 2017. CPI = Consumer price index. Fig.3. Thomson Reuters Datastream, as at 2 October 2017. PCE = Personal consumption expenditures. Fig.4. Thomson Reuters Datastream, as at 2 October 2017. P/E = Price-to-earnings. RH = Right hand.

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