Leaders | Still aloft

Inflation will be harder to bring down than markets think

Investors are betting on good times. The likelier prospect is turbulence

Feb 16th 2023

GIVEN HOW woefully stock and bond portfolios have performed over the past year or so, you may not have noticed that financial markets are floating high on optimism. Yet there is no other way to describe today's investors, who since the autumn have increasingly bet that inflation, the world economy's biggest problem, will fall away without much fuss. The result, many think, will be cuts in interest rates towards the end of 2023, which will help the world's major economies—and most importantly America—avoid a recession. Investors are pricing stocks for a Goldilocks economy in which companies' profits grow healthily while the cost of capital falls.

In anticipation of this welcome turn of events the S&P 500 index of American stocks has risen by nearly 8% since the start of the year. Companies are valued at about 18 times their forward earnings—low by post-pandemic standards, but at the high end of the range that prevailed between 2002 and 2019. And in 2024 those earnings are expected to surge by almost 10%.

It is not just American markets that have jumped. European stocks have risen even more, thanks partly to a warm winter that has curbed energy prices. Money has poured into emerging economies, which are enjoying the twin blessings of China abandoning its zero-covid policy and a cheaper dollar, the result of expectations of looser monetary policy in America.

This is a rosy picture. Unfortunately, as we explain this week, it is probably misguided. The world's battle with inflation is far from over. And that means markets could be in for a nasty correction.

For a sign of what has got investors' hopes up, look at America's latest consumer-price figures, released on February 14th. They showed less inflation over the three months to January than at any time since the start of 2021. Many of the factors which first caused inflation to take off have dissipated. Global supply chains are no longer overwhelmed by surging demand for goods, nor disrupted by the pandemic. As demand for garden furniture and games consoles has cooled, goods prices are falling and there is a glut of microchips. The oil price is lower today than it was before Russia invaded Ukraine a year ago. The picture of falling inflation is repeated around the world: the headline rate is falling in 25 of the 36 mainly rich countries in the OECD.

Yet fluctuations in headline inflation often mask the underlying trend. Look into the details, and it is easy to see that the inflation problem is not fixed. America's "core" prices, which exclude volatile food and energy, grew at an annualised pace of 4.6% over the past three months, and have started gently accelerating. The main source of inflation is now the services sector, which is more exposed to labour costs. In America, Britain, Canada and New Zealand wage growth is still much higher than is consistent with the 2% inflation targets of their respective central banks; pay growth is lower in the euro area targets of their respective central banks, pay growth is lower in the euro area, but rising in important economies such as Spain.

That should not be a surprise, given the strength of labour markets. Six of the G7 group of big rich countries enjoy an unemployment rate at or close to the lowest seen this century. America's is the lowest it has been since 1969. It is hard to see how underlying inflation can dissipate while labour markets stay so tight. They are keeping many economies on course for inflation that does not fall below 3-5% or so. That would be less scary than the experience of the past two years. But it would be a big problem for central bankers, who are judged against their targets. It would also blow a hole in investors' optimistic vision.

Whatever happens next, market turbulence seems likely. In recent weeks bond investors have begun moving towards a prediction that central banks do not cut interest rates, but instead keep them high. It is conceivable—just—that rates stay high without seriously denting the economy, while inflation continues to fall. If that happens, markets would be buoyed by robust economic growth. Yet persistently higher rates would inflict losses on bond investors, and continuing elevated risk-free returns would make it harder to justify stocks trading at a large multiple of their earnings.

It is far more likely, however, that high rates will hurt the economy. In the modern era central banks have been bad at pulling off "soft landings", in which they complete a cycle of interest-rate rises without an ensuing recession. History is full of examples of investors wrongly anticipating strong growth towards the end of a bout of monetary tightening, only for a downturn to strike. That has been true even in conditions that are less inflationary than today's. Were America the only economy to enter recession, much of the rest of the world would still be dragged down, especially if a flight to safety strengthened the dollar.

There is also the possibility that central banks, faced with a stubborn inflation problem, do not have the stomach to tolerate a recession. Instead, they might allow inflation to run a little above their targets. In the short run that would bring an economic sugar rush. It might also bring benefits in the longer run: eventually interest rates would settle higher on account of higher inflation, keeping them safely away from zero and giving central banks more monetary ammunition during the next recession. For this reason, many economists think the ideal inflation target is above 2%.

Yet managing such a regime shift without wreaking havoc would be an enormous task for central banks. They have spent the past year emphasising their commitment to their current targets, often set by lawmakers. Ditching one regime and establishing another would be a once-in-a-generation policymaking challenge. Decisiveness would be key; in the 1970s a lack of clarity about the goals of monetary policy led to wild swings in the economy, hurting the public and investors alike.

Back to Earth

So far central bankers in the rich world are showing no signs of reversing course. But even if inflation falls or they give up fighting it, policymakers are unlikely to execute a flawless pivot. Whether it is because rates stay high, recession strikes or policy enters a messy period of transition, investors have set themselves up for disappointment. ■

This article appeared in the Leaders section of the print edition under the headline "Still aloft"

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February 18th 2023

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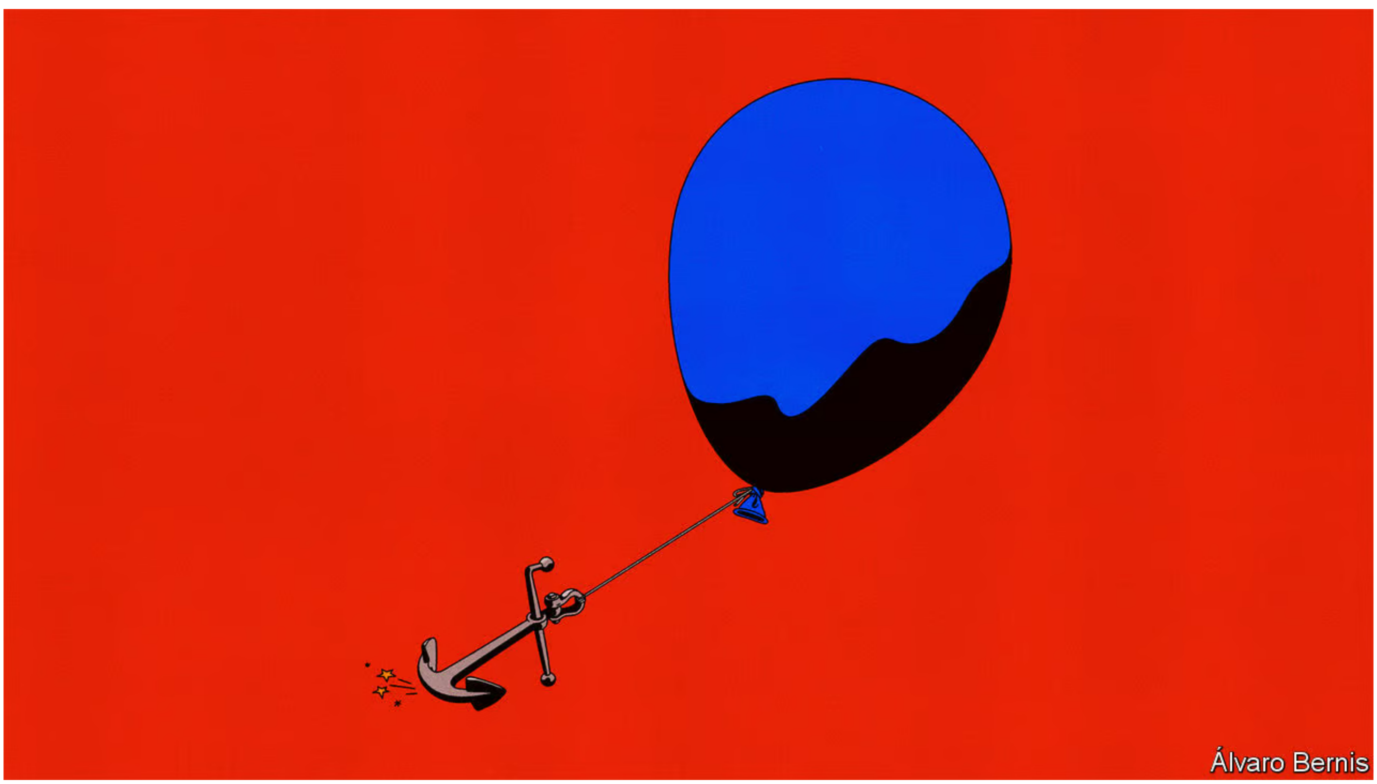

Álvaro Bernis

Nov 15th 2022

Save Share Give

INVESTORS HAVE swooned at the good news. Since early October European shares have risen, with optimists declaring an end to the continent's energy crisis in sight. Chinese stocks have jumped at recent talk that Xi Jinping will abandon his "zero-covid" policy, and as regulators have loosened their curbs on the property sector. On November 10th, on the news that America's consumer-price inflation had come in slightly below economists' expectations, the tech-heavy NASDAQ index rose by 7%, one of the biggest ever daily moves, as investors priced in lower interest rates.

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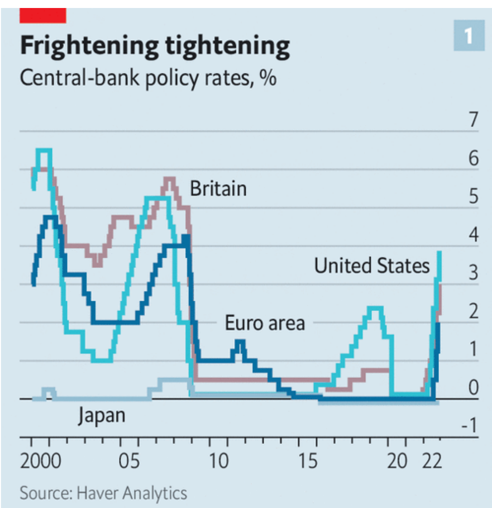

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But take a step back, and the outlook has in fact darkened in recent weeks. The global economy is slowing, perhaps into a recession, as central banks ramp up interest rates to battle a once-in-a-generation surge in prices (see chart 1). Even with one month of better-than-expected data for America, there is scant evidence that inflation is anywhere near defeated (see chart 2). Indeed, in much of the world it is broadening out.

For most of this year people have worried about a downturn. In June Google searches for "recession" neared a record high. For a long time, however, the gloomy rhetoric ran ahead of reality. Output in the median rich country increased by about 1.3% from the end of 2021 to the third quarter of this year—not spectacular, but not bad. In the year to September the average unemployment rate in the OECD, a club of mostly rich countries that accounts for about 60% of global GDP, fell by close to one percentage point. Joblessness in the euro area hit an all-time low. Consumer spending was strong, with hotels, planes and restaurants packed the world over.

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Now reality has caught up with the rhetoric. Higher borrowing costs are starting to bite. In many countries, including Canada and New Zealand, house prices are falling as homebuyers face expensive mortgages. Housebuilders are cancelling projects, and homeowners are feeling less wealthy. Other companies are also reining in spending. In their latest monetary-policy report the Bank of England's researchers note that costlier finance is "weighing on investment intentions". The minutes of a recent Federal Reserve meeting observe that fixed investment by businesses has "already started to respond to the tightening of financial conditions".

Deteriorating economic conditions are beginning to show up in "real-time" data. Goldman Sachs, a bank, publishes a "current-activity indicator", a month-by-month measure of economic strength. Last month, for the first time since the initial covid-19 lockdowns in 2020, rich-world economies appeared to shrink (see chart 3). Likewise, a global survey of purchasing managers indicates a contraction for the first time since June 2020. Since July a "nowcast" of global annualised GDP growth produced by JPMorgan Chase, another bank, has fallen by half.

Optimists point to strong labour markets. America's formidable jobs machine has slowed, but is still whirring, adding more than 250,000 positions in October. Elsewhere, though, signs of weakness are emerging. Claudia Sahm, an economist, has suggested that a recession is nigh when the average of the unemployment rate over the past three months rises by at least 0.5 percentage points relative to its low during the previous year. We find that eight out of 31 rich countries currently meet this criterion, including Denmark and the Netherlands. This is not a high proportion compared with, say, the beginning of the global financial crisis of 2007-09. But it does signal that a serious slowdown is now under way.

The "Sahm rule" reveals another important truth: that different countries are moving at very different speeds. Aside from America, a number of places, including Australia and Spain, are still growing at a decent rate. Yet others are in trouble. Sweden, where high interest rates are hurting a particularly frothy housing market, is losing steam fast. Britain is now almost certainly in recession. In Germany sky-high energy prices are forcing industrial shutdowns. It may be faring the worst of all rich countries.

How severe will the downturn be? Households in rich countries are still sitting on trillions of dollars of "excess savings", which they accumulated in 2020-21 from stimulus cheques and other fiscal support. This money will allow them to continue spending, even in the face of falling real incomes. New research by Goldman Sachs finds that large private-sector saving surpluses are associated with less severe recessions. And healthy savings pots mean economic pain is less likely to translate into financial distress. Mortgage-delinquency rates are actually declining in America, and are extremely low in New Zealand and Canada.

Marching orders

Labour markets are weakening, but a rise in unemployment like that seen after the financial crisis is unlikely. This is because demand for labour has a long way to fall before it matches supply. Early this year the two were seriously out of whack, with the number of unfilled vacancies across the OECD peaking at 30m, according to our calculations. Now as demand falls, vacancies rather than jobs seem once again to be taking the strain. We estimate that the number of unfilled positions has fallen by a tenth since the high, but the number of filled posts is static.

Much depends on the path of inflation. Central banks are willing to induce a recession in order to lower it. Higher rates may bring "some softening of labour-market conditions", as Jerome Powell, the chairman of the Fed, noted earlier this month. "We do think that [raising rates] is going to dampen demand, we're not going to pretend this is pain-free," warns Philip Lane, chief economist of the European Central Bank. Both economic theory and data over the past seven decades suggest that falling GDP is associated with a large decline in the speed of price rises. But the lags between tighter monetary policy and lower inflation are not well understood. Central banks may have to cause more pain than they anticipate.

In some countries lower energy and food prices are helping to drag down the headline rate of inflation. America's recent figures for October were better than economists expected. In general, though, prices are not heading in the direction that central bankers would like. Inflation "surprises" across the rich world, when reported data come in higher than forecast, are still common (see chart 4). According to figures released on November 16th, inflation in Britain was 11.1% in October, well above economists' expectations. On the same day, Canadian data showed no sign of waning inflation. Almost everywhere "core" inflation, which reflects underlying price pressure better, is rising. In three dimensions—breadth, wages and expectations—rich-world inflation is getting more, not less, entrenched.

Begin with breadth. When the inflationary surge started last year, it was confined in most countries to a small number of goods and services. In America it was second-hand cars. In Japan it was food. In Europe it was energy. This provided false comfort to pundits, many of whom assumed that once the prices of these few components stopped rising, overall inflation would fizzle out.

*Australia, Britain, Canada, France, Germany, Italy, Japan, South Korea, Spain and United States

Sources: Citigroup; Federal Reserve Bank of Cleveland; Morning Consult; Raphael Schoenle

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In fact, the inflation virus has spread. We analysed the consumer baskets of 36 mostly rich countries. In June 60% of prices in the median basket were rising by more than 4% year on year. Now 67% are. Even in Japan, the land of low inflation, the prices of a third of the basket are rising by more than 4%. This broadening out is in part due to an exceptionally strong dollar, which raises inflation by making imports more expensive. But it is more to do with what is happening in domestic economies.

This is where the second dimension—wages—comes in. Pay is a guide to the future path of inflation: when companies' labour costs rise, they tend to pass them on to customers in the form of higher prices. Inflation optimists point to data from America, where there is some evidence of a pay slowdown, albeit from increases of 6% or more year on year. Growth in Britain also seems to have peaked at a high-but-no-longer-rising rate.

Elsewhere, though, there is not much evidence of restraint. New research from Pawel Adrjan of Indeed, a jobs website, and Reamonn Lydon of the Central Bank of Ireland suggests that nominal pay in euro-zone job postings is rising by more than 5% year on year, and is still accelerating. French wage inflation "has further to go", reckons JPMorgan. In Germany IG Metall, a big union for metals and engineering workers, is seeking a pay rise of up to 8%. In New Zealand, Norway and Sweden pay growth is still rising. This is not what you would expect at a time when the economic outlook is dire.

The third dimension is expectations. Alternative Macro Signals, a consultancy, runs millions of news articles in several languages through a model to construct a "news inflation pressure index". The index, which has proved to be a good predictor of official numbers, is still elevated. Similar evidence comes from Google-search data, which suggests that global interest in inflation has never been so high.

Survey-based measures of expectations similarly provide no evidence of weakening inflation. Figures put together by the Cleveland Fed, Morning Consult, a data company, and Raphael Schoenle of Brandeis University gauge the public's inflation expectations in various rich countries. According to the survey for October, in the median country the public reckons prices will rise by 5% over the next year, as it has in previous months (see chart 5). The inflation expectations of companies—the economic actors that actually set prices—are just as concerning. A survey by the Cleveland Fed, based on research by Bernardo Candia, Olivier Coibion and Yuriy Gorodnichenko, three economists, finds that American firms currently expect inflation of 7% over the next year, the highest level since the survey began in 2018.

Painful ignorance

Everyone can agree on one thing about the past year. It has demonstrated just how poorly economists understand inflation, including both what causes it and what causes it to persist. It is likely, therefore, that economists will also struggle to predict when inflation will cool. Optimists hope that prices will once again take people by surprise, with their rise slowing sooner than expected. But it seems more likely that inflation will prove stubborn even as the economy slows. That will leave policymakers with a grim choice: to squeeze the economy tighter and tighter, or to let prices spiral. ■

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Even outside America, inflation is starting to look entrenched

Five indicators suggest Anglophone countries are suffering the most


Alamy

May 14th 2022 | SAN FRANCISCO

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INFLATION DOMINATES the American popular psyche to an extent not seen since the 1980s, when prices were last rising at the current pace. Much like complaining about the weather or last night's basketball play-offs, moaning about higher prices has become a conversation starter. According to figures published on May 11th, consumer prices rose by 8.3% in April, compared with the previous year. A day earlier, President Joe Biden called fighting inflation his "top domestic priority". Newspapers are publishing four times as many stories mentioning inflation as they did a year ago; several polls suggest that Americans believe inflation is a bigger problem for their country than the war in Ukraine. But America is not alone. Inflation is also becoming baked into everyday life in other parts of the rich world.

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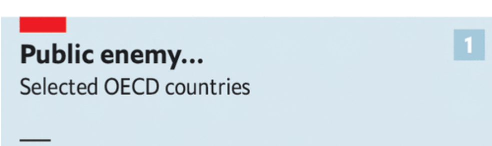
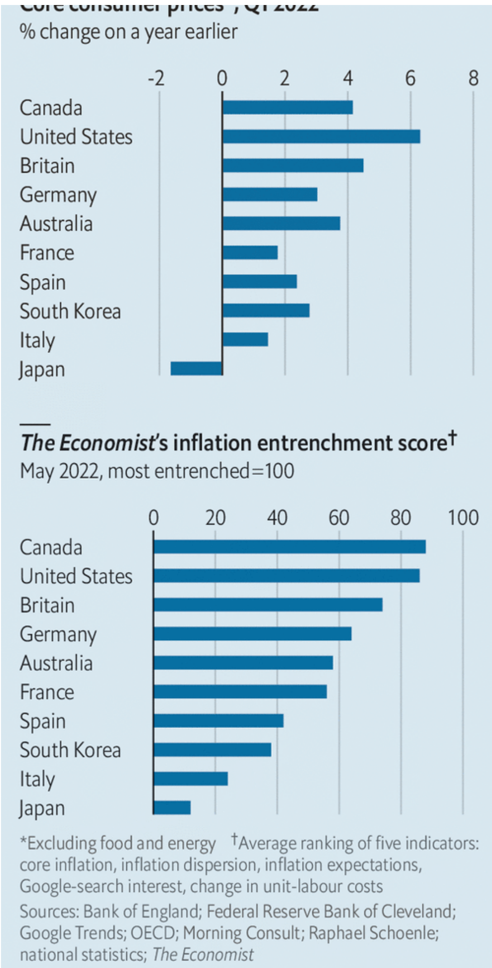
The Economist has gathered data on five indicators across ten big economies—"core" inflation, which excludes food and energy prices; the dispersion in inflation rates for the sub-components of the consumer-price index; labour costs; inflation expectations; and Google searches for inflation. To gauge where inflation has become most pervasive, we rank each country according to how it fares on each measure, and then combine these ranks to form an "inflation entrenchment" score.

Continental Europe, so far at least, seems to have escaped the worst of the scourge. Inflation is leaving barely a trace on Japan. But it is entwining itself around Anglophone economies. Canada is faring slightly worse even than America. Britain has a big problem on its hands (see chart).



A few factors explain the differences. Total fiscal stimulus across Anglophone countries in 2020-21 was about 40% more generous than in other rich places, according to our estimates. It was also more focused on handouts to households (such as stimulus



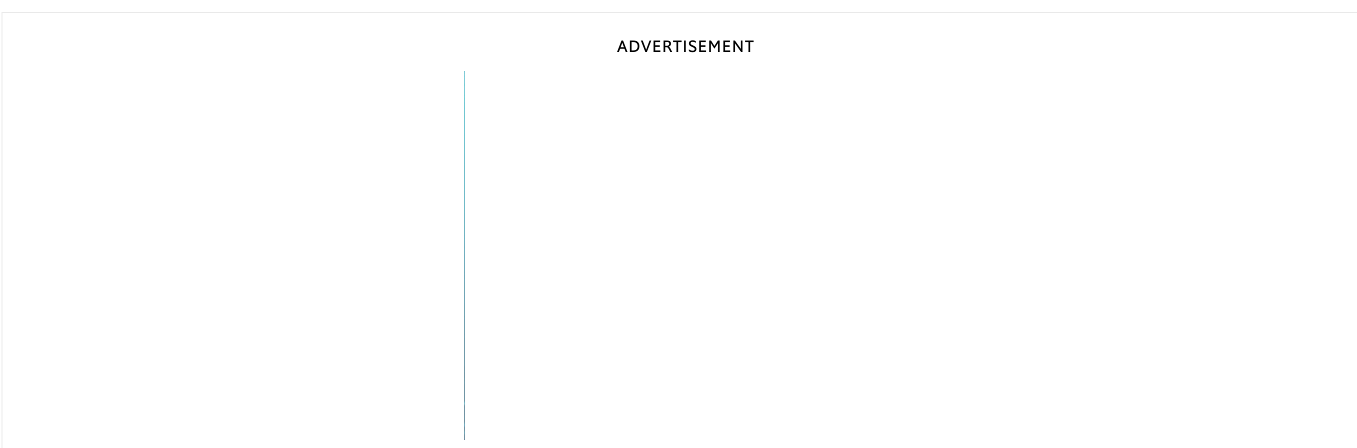
The Economist

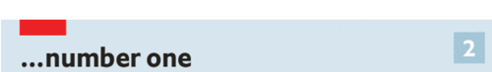
cheques). That may have further stoked demand. Monetary policy in the euro area and Japan was already ultra-loose before the pandemic, limiting the amount of extra stimulus central banks could provide. Britain's inflation may also reflect an idiosyncratic factor: Brexit. It turns out that breaking with your largest trading partner causes costs to rise.

The simplest component of our ranking is the rate of core inflation. This measure gives a better sense of underlying price pressure. Among our ten countries, America leads the pack (though core inflation is above average pretty much everywhere).

A second measure, of dispersion, helps capture how broadly based price pressures are. Headline inflation being driven by one or two items—say, the cost of a restaurant meal—is less worrisome than if the price of everything is going up quickly. We divide a country's consumer-goods basket into as many as 16 components, then calculate the share where the inflation rate exceeds 2%. In Japan just a quarter cross that threshold. But in Australia more than two-thirds do. JPMorgan Chase, a bank, breaks down Britain's consumer-price index into 85 components, and finds that inflation rates for 69% of them are running above their 1997-2019 averages.

Inflation could also spiral if workers demand higher wages to compensate them for rising prices (and firms raise their prices in turn). Unit labour costs, which measure the relationship between what workers are paid and the value of what they produce, are rising far faster than their long-run average in many countries. On May 5th America's statisticians revealed that these rose by 7% in the first quarter, compared with a year ago, up from a pre-pandemic average of around 2%. Michael Saunders of the Bank of England has noted that with pay deals being struck at up to 5% a year, but productivity growth of only around 1%, Britain's unit-labour-cost growth is probably "well above the pace consistent with the inflation target [of 2%]".





Our last two measures assess households' expectations. The higher these remain, the more likely it is that inflation becomes

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embedded. One proprietary data set, provided to *The Economist* by researchers at the Federal Reserve Bank of Cleveland, Morning Consult, a consultancy, and Raphael Schoenle of Brandeis University, is a rare reliable cross-country gauge of public inflation expectations. In May 2021 a respondent in the median rich country thought inflation over the next 12 months would be 2.3%. Now they expect a rate of 4.5%; Canadians, an even higher 6%. A measure of Google searches also suggests the subject is weighing on people's minds. Britons now search more frequently for "inflation" than they do for Taylor Swift. ■

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