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Daily Observations

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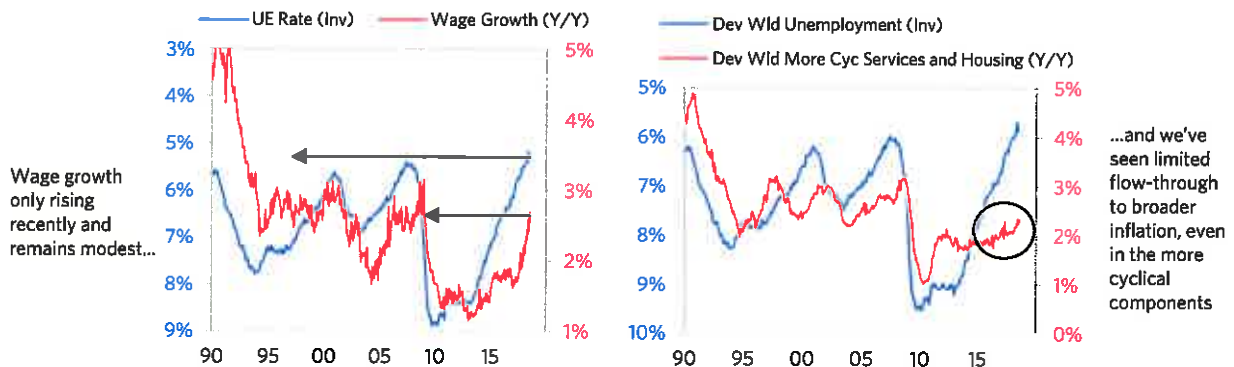
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Any Way You Cut It, Cyclical Strength Isn't Flowing Through to Higher Inflation across the Developed World

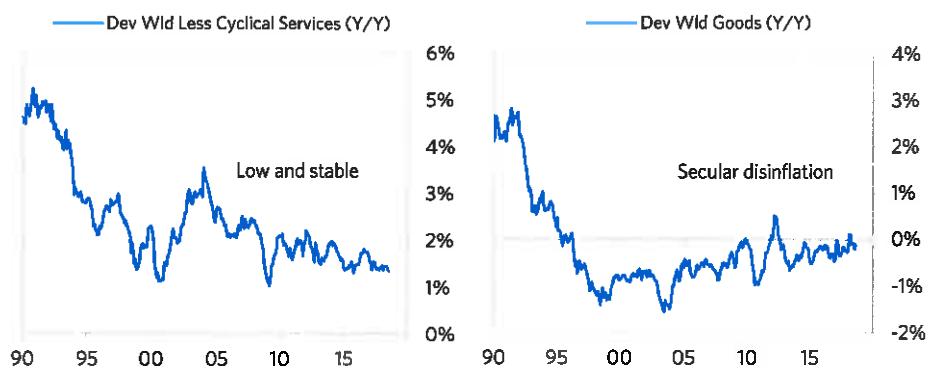
In recent *Observations*, we have dug deeply into US inflation in order to illustrate that no matter how you look at it (whether it is bottom-up by type of inflation or by sector) that cyclical inflation pressures are muted and that other forces like automation and globalization are also keeping inflation down. In these *Observations*, we look at what is happening across the developed world where we largely observe the same dynamics. Whether we look at countries like the UK and Japan that are further along in their cyclical expansion or Europe, which is not quite as far, the normal cyclical dynamics have been at best loose and modest in size. We've seen tightening labor markets only lead to modest rises in wages and little pickup in inflation even in the domestic-focused and labor-intensive sectors. Plus, any rising cyclical pressure has been offset by continued weakness in inflation for goods and less cyclical services (like telecom). While it is hard to do a precise attribution of what is driving the weakness in inflation in either cyclical or less cyclical sectors, the forces are clearly global and secular. As a result, it is important not to over-focus on tightening cyclical conditions as a sign that overall inflation will rise and central banks need to tighten aggressively. That plus the low level of inflation at this point in the cycle are big reasons we're less concerned about a modest cyclical overshoot over the next year or two than about central banks' ability to reverse a downturn and deflation during the next downturn whenever that occurs.

Before showing what we are seeing across countries, the charts below show what we are seeing for the aggregate, as in this case they largely capture what we are seeing across the board. As the chart on the left shows, despite the full recovery in employment across the developed world, wages have only begun to rise recently and remain at modest levels. The flow-through of tighter labor markets to broader inflation has also been remarkably muted this cycle, even for sectors like housing and some services that tend to be more cyclical (as we show on the right).

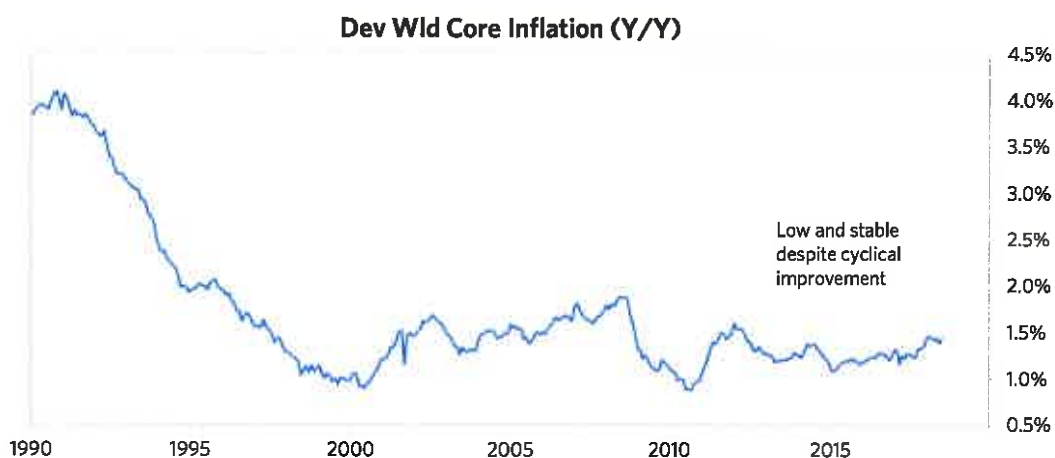


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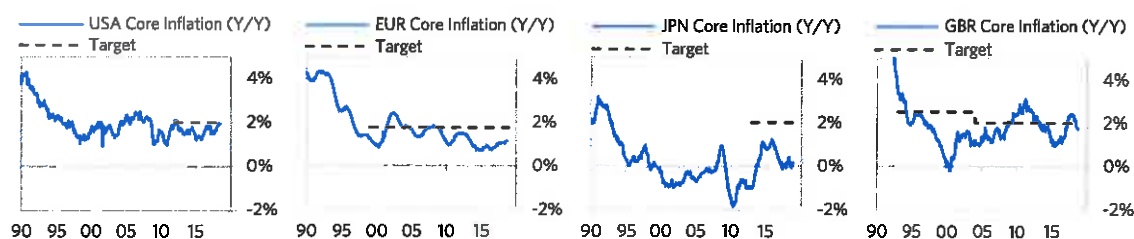
At the same time, continued global disinflation in goods and stable inflation in less cyclical services have contributed to the very low inflation rates we've seen, even as the expansion has gotten more advanced.



Putting these pieces back together, inflation has been remarkably stable between 1% and 1.5% over the last five years, despite a significant economic recovery.



Looking across the developed world, core inflation remains low and below central banks' targets.



When we take a closer look at the inflation dynamics within the major countries, basically everything suggests that the normal cyclical linkages have been looser. Despite tight labor markets, we haven't seen much of a flow-through to wages and inflation, even in the cyclically sensitive sectors of the economy. Wage and price inflation across categories have been below 3% and/or below their 30-year averages.

Employment Flow-Through to Inflation by Country

	Core Inflation		Unemployment Rate		Wage Growth		More Cyc Services and Housing Inflation		Less Cyc Services and Goods Inflation	
	Current	Percentile vs. Past 30 Years	Current	Percentile vs. Past 30 Years	Current	Percentile vs. Past 30 Years	Current	Percentile vs. Past 30 Years	Current	Percentile vs. Past 30 Years
USA	1.9%	57%	3.9%	1%	2.7%	47%	3.0%	64%	1.3%	52%
EUR	1.1%	26%	8.2%	22%	2.3%	40%	2.1%	35%	0.4%	27%
JPN	0.2%	53%	2.5%	16%	1.1%	70%	0.3%	54%	-0.3%	50%
GBR	1.7%	43%	4.0%	0%	3.5%	42%	2.0%	4%	1.0%	70%

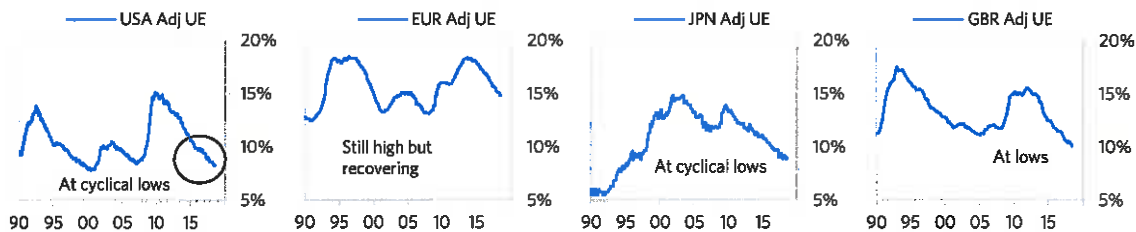
Not an issue anywhere

Way below long-term averages in USA, EUR, and GBR; very low in JPN

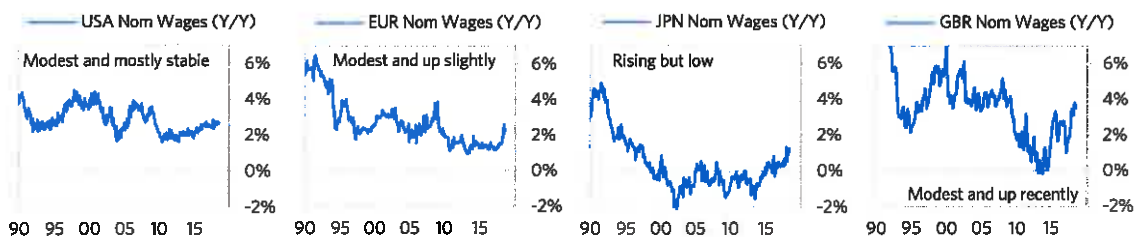
A touch high in USA over past few years; low elsewhere

Low across the board

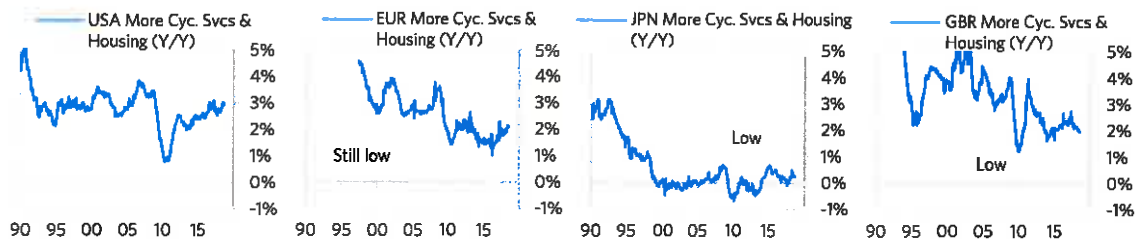
Below, we scan across countries, showing the cyclical pressures on inflation and actual inflation rates across sectors. These charts suggest that inflation isn't yet a big deal anywhere, despite strong cyclical conditions. The first charts show that unemployment rates are cyclically low across countries, though less so in Europe where higher unemployment rates in the periphery are offsetting low levels in Germany. Note that we are showing our adjusted measure of unemployment, which takes into account people who are officially unemployed as well as other groups who could represent hidden excess labor market slack, like part-time workers or discouraged workers.



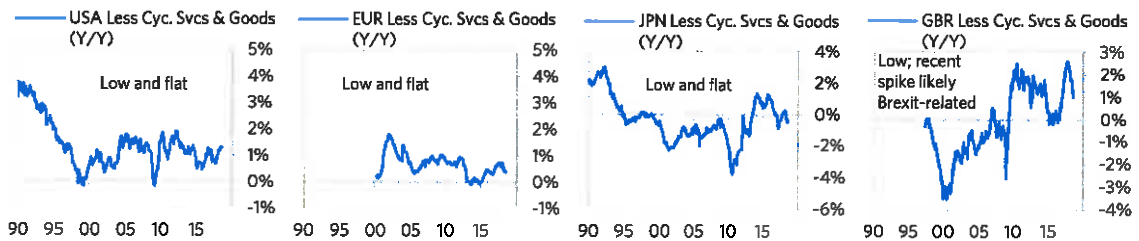
Low unemployment rates are flowing through to some pickup in wage inflation. But wage inflation rates are at low to moderate levels everywhere. Wage pressures are not a material consideration for inflation yet.



These cyclical conditions are flowing through to higher inflation in more cyclical sectors, but even in these buckets inflation isn't a big deal. In the US, these components are running at around 3%, but still below prior cycles. In other countries, the components are rising but are even more muted.

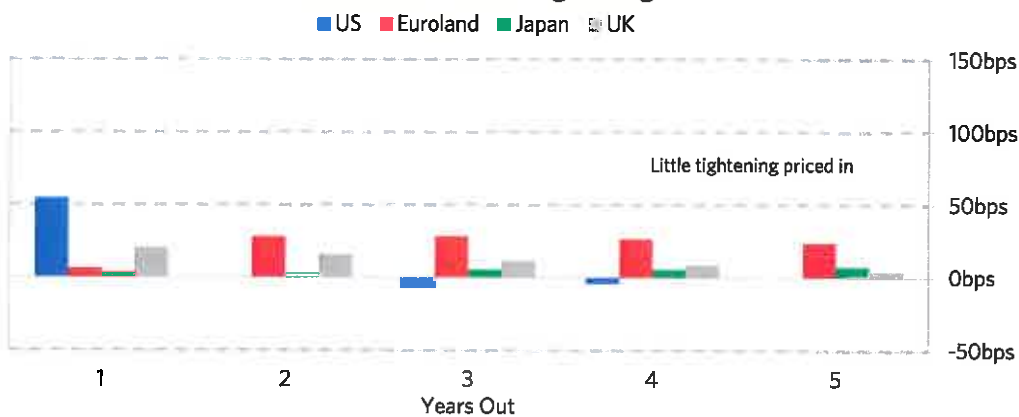


The modest rise in cyclical pressures shown above is being muted by low inflation in less cyclical sectors like goods (impacted by automation and globalization) and less cyclical services. We think these disinflationary pressures are likely to persist, and instead of offsetting they will reinforce whatever downward cyclical pressures on inflation occur during the next downturn. Some of the fluctuations we see across the countries below are due to one-off currency swings like those that impacted the UK following Brexit.



So far, central banks have been cautious in tightening relative to the more normal cyclical pressures, given the asymmetric nature of the risks and some of the more secular disinflationary pressures discussed above. More recently, the pace of tightening has picked up, particularly in the US and once we consider the shift toward winding down QE. Looking ahead, we see most of the risks to asset prices and the economy around central banks tightening more in line with cyclical pressures at a time when not much additional tightening is discounted.

Discounted Annual Tightening



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