Bridgewater®
Daily Observations

September 14, 2018

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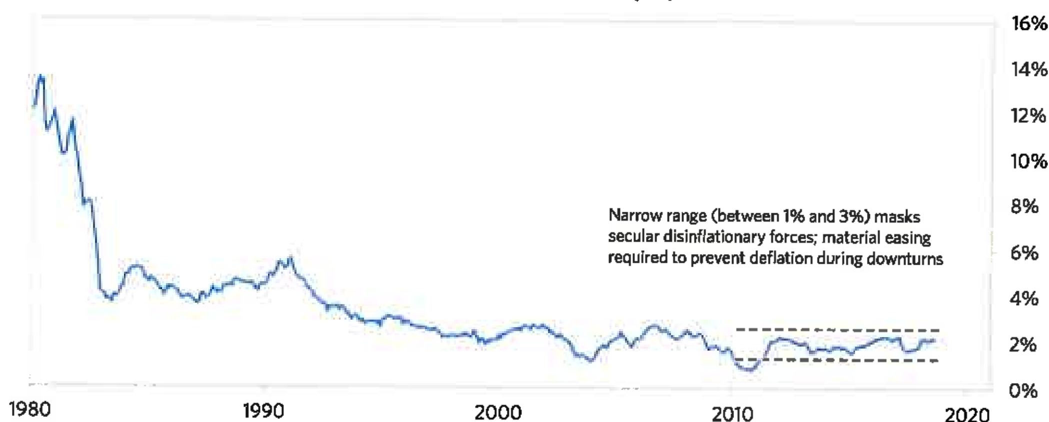
Inflation Is One Place Where Markets Are Pricing a Higher Probability of Continued Success for the Fed Despite Circumstances That Look More Challenging

As we've written in prior *Observations*, getting the policy rate right late in expansions is tougher than in mid-cycles, and the Fed's ability to ease effectively is secularly diminished with rates near zero. In coming years, we expect these challenges to be significant, while markets are pricing in stable inflation and a fairly narrow range of monetary policy outcomes needed to achieve that.

Thursday's inflation print showed a continuation of muted inflation pressures even as the cycle has progressed. The relatively muted increases in inflation late in the cycle have been a feature of business cycles for a long time now, as secular disinflationary forces have dampened cyclical upward pressures. Over the next year, we think it is more likely than not that this will continue, with inflation rising only modestly despite very tight labor markets and the Fed continuing to gradually tighten in response to cyclical conditions. We see some upside risks to inflation if the trade tensions escalate materially. More important than modest moves in the near term, however, are the longer-term downside risks. The volatility of inflation to the downside has also been fairly muted in recent decades, as the Fed has been able to ease enough in downturns to offset combined cyclical and secular disinflationary pressures. The Fed has less room to maneuver with rates so close to zero, which makes backstopping inflation in the next downturn more difficult, while political fragmentation raises questions about whether the fiscal policy lever will be a feasible option for providing additional stimulus.

The chart below shows how core inflation has fallen secularly and remained in a narrow band for the past few decades, as well as how stable it continues to be in this expansion. The pricing for long-term inflation is largely consistent with this stability continuing over the next 10 years (breakeven inflation is at 2.2%).

Core CPI Inflation (Y/Y)



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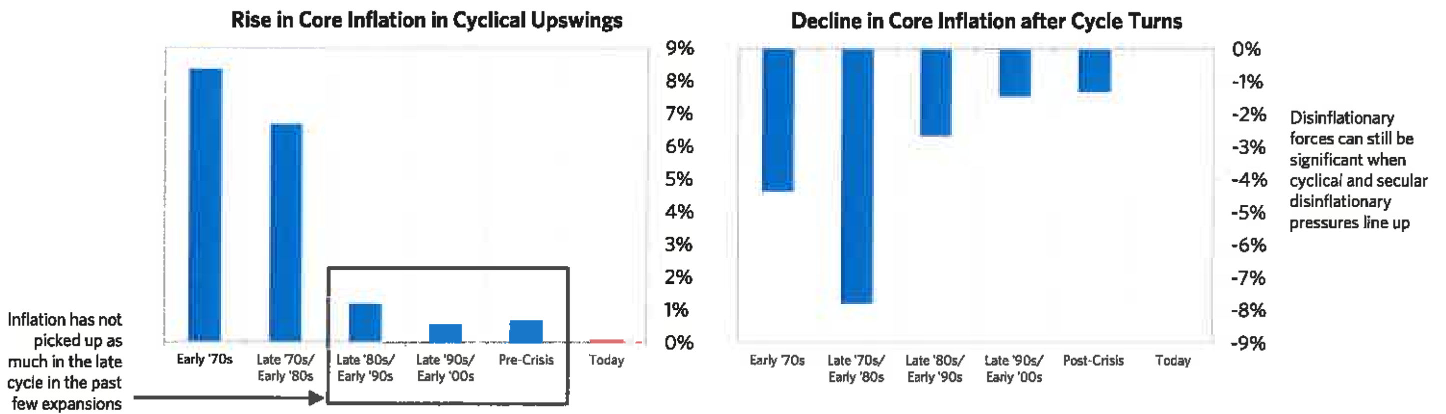
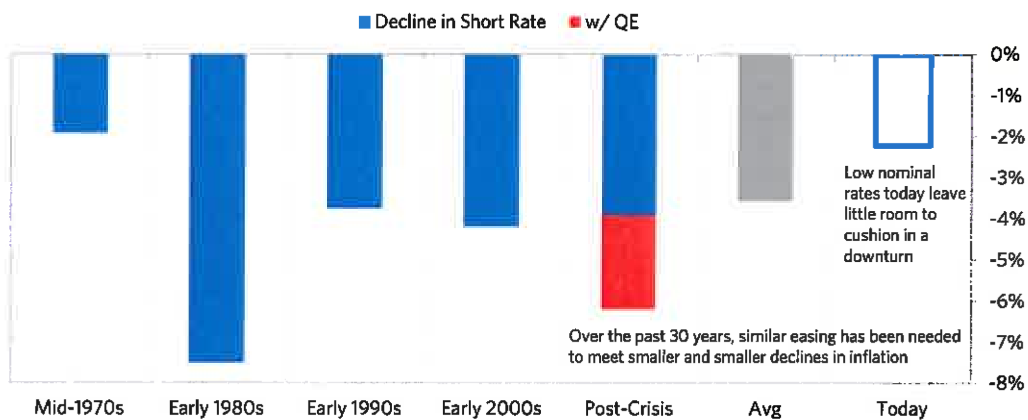
The emergence of crosscurrents that have been netting to roughly stable inflation is highlighted in the charts below. The left-hand chart illustrates how the cyclical increases in inflation in recent decades have been modest, as secular disinflationary forces dampened the flow-through of stronger cyclical conditions to higher inflation. As a result, the amount that inflation accelerated in cyclical upswings shrank. The moves down in inflation when the cycle turns tend to happen more quickly as cyclical forces and secular forces line up, but this disinflation has also been contained by easings.



In order to stabilize the economy and ultimately arrest falls in inflation during recessions, the Fed has typically had to ease hundreds of basis points, and when the last cycle turned it had to aggressively purchase assets as well. It took that plus a meaningful fiscal easing to get the economy to start rebounding, and as we look to the next downturn, it is likely that the Fed's ability to ease effectively may once again be tested.



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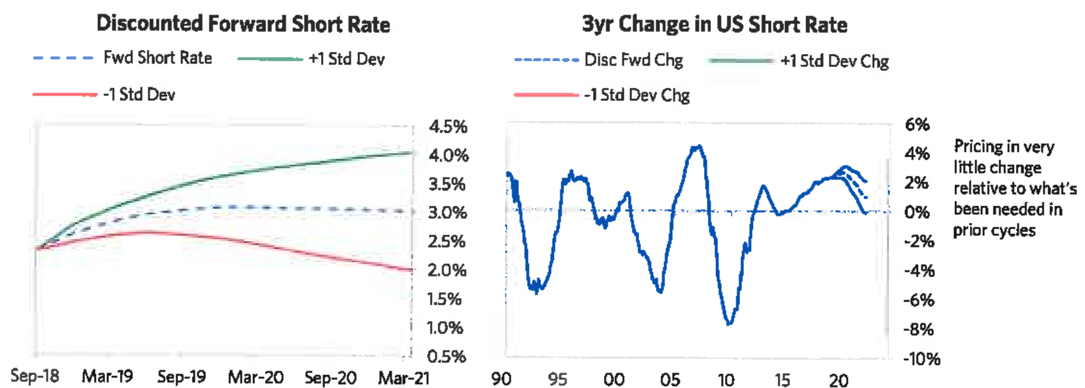
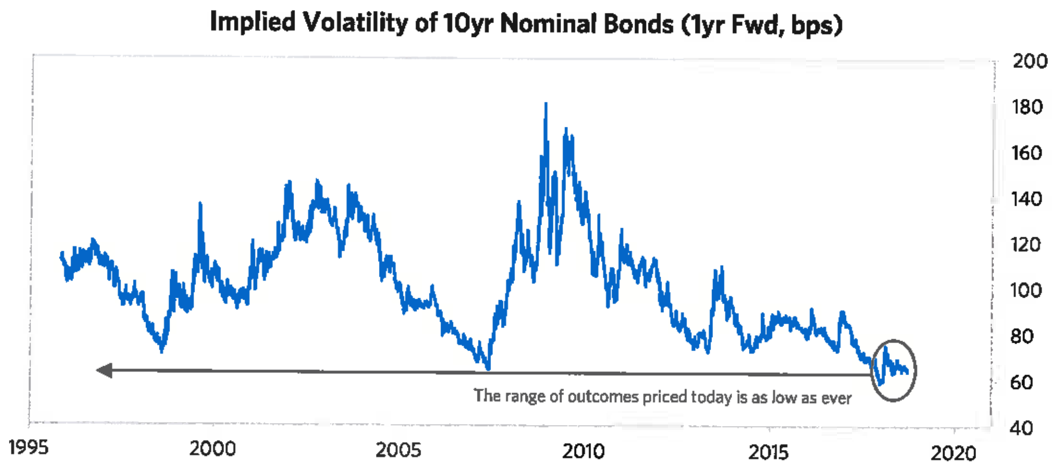
Market Pricing Is Consistent with the Fed Being Able to Achieve Stable Inflation without Major Swings in Policy

When we look at the path of monetary policy priced in for coming months, it looks to us largely consistent with what we would expect the Fed to do based on normal cyclical linkages, even absent a major rise in inflation. The flatness of the curve more than a year out suggests that little additional tightening will be needed beyond that time, which may be right or wrong. More remarkable is that markets aren't pricing in much of a possibility of a downturn—and how much work the Fed may need to do to reverse it. As reflected in the options pricing shown below, the range of outcomes priced in to the downside is quite small.



Looking at the implied volatility of 10-year bonds is another rough way to capture the discounted range of outcomes for both inflation and monetary policy. This range is priced to be smaller today than it has been historically. There are, of course, good reasons for it to be lower now than it was throughout much of the past few decades, with proximity to the zero lower bound being one of them. But this market pricing of roughly 60bps standard deviation around the bond yield is still consistent with a fairly narrow range of outcomes.



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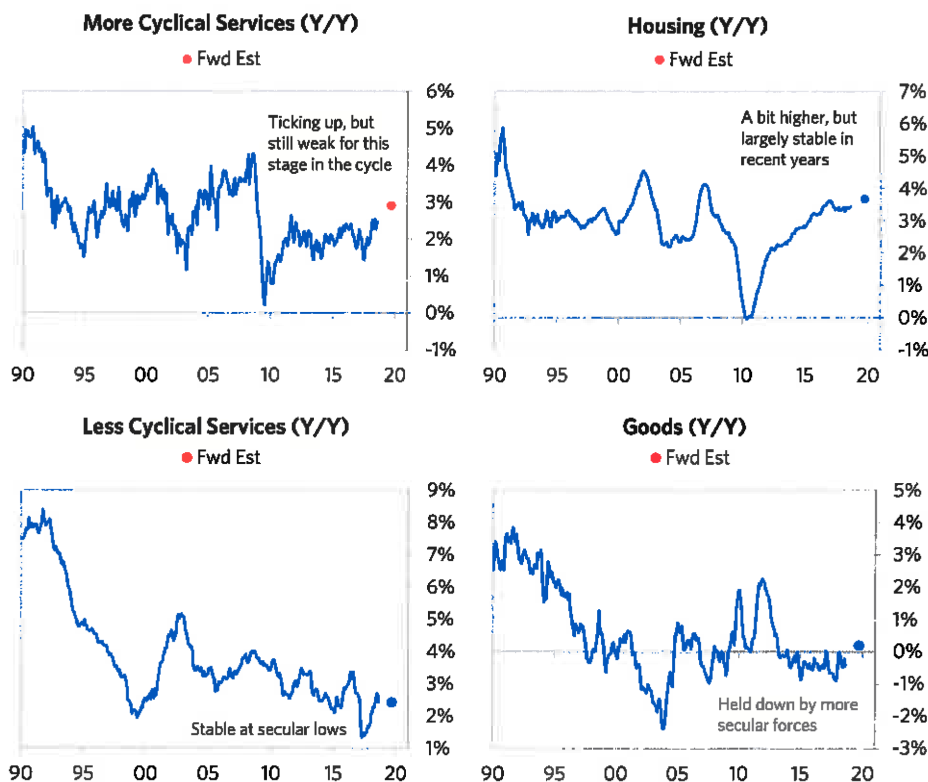
Looking Bottoms-Up at Inflation Highlights Muted Cyclical Supports and Ongoing Secular Downward Pressures

In order to better understand the recent modest pickup in inflation and the likely trajectory going forward, we find it helpful to break overall inflation into components that align with its major drivers. This also helps us get a better sense of how they would net out. On the cyclical side, housing inflation has clearly accelerated, but it has flattened out more recently. More cyclical services inflation, however, remains very muted for where we are in the expansion. Persistent goods deflation exemplifies the drag from more secular forces, including globalization and automation, which has been compounding cyclical disinflationary pressures during recessions. We expect that the higher tariffs that have been announced so far will have a modest impact of about 20bps on overall inflation and a larger one-off impact on goods inflation, but unless globalization reverses in a more material way, this is not a big deal.

Inflation (Y/Y) Across Baskets of Goods and Services



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The sector breakdown a level down shows how broad-based the lack of inflationary pressure has been. Housing inflation is a bit higher than it was before the crisis, but not by much. Inflation across major categories is low and relatively stable. We think that increases in inflation going forward due to cyclical pressures are likely to be gradual, and that volatility is more likely to come from the risks to the downside the next time cyclical disinflationary pressures in a recession compound the more secular disinflationary forces.

Inflation Breakdown by Component

Across categories, inflation is largely as low or lower than it has averaged

		Inflation (Y/Y)				Contribution to Inflation (Y/Y)		
Component	**Nominal Weight in Core CPI**	**Today**	**6m Ago**	**Average 2005-2007**	**10yr Avg**	**Today**	**6m Ago**	**Average 2005-2007**
Core CPI		2.1%	2.2%	2.3%	1.8%	2.1%	2.2%	2.3%
Housing	48%	3.1%	3.0%	2.9%	2.0%	1.5%	1.5%	1.4%
Private Transportation	15%	2.2%	2.3%	0.8%	1.8%	0.3%	0.3%	0.1%
Medical Care	11%	1.5%	2.2%	4.2%	2.9%	0.2%	0.2%	0.3%
Recreation	7%	0.2%	0.7%	0.9%	0.5%	0.0%	0.1%	0.1%
Apparel	4%	-2.4%	1.2%	-0.4%	0.6%	-0.1%	0.0%	0.0%
Communication	5%	-0.2%	-3.0%	-1.2%	-1.2%	0.0%	-0.1%	0.0%
Education	4%	2.7%	1.8%	6.1%	3.7%	0.1%	0.1%	0.2%
Personal Care	3%	1.7%	1.8%	2.5%	1.4%	0.1%	0.1%	0.1%
Public Transportation	1%	0.0%	-0.1%	3.3%	0.6%	0.0%	0.0%	0.0%
Tobacco	1%	2.8%	3.9%	4.9%	6.4%	0.0%	0.0%	0.0%
Alcohol	1%	1.3%	1.3%	2.5%	1.6%	0.0%	0.0%	0.0%
Headline CPI		2.5%	2.4%	3.2%	1.6%			

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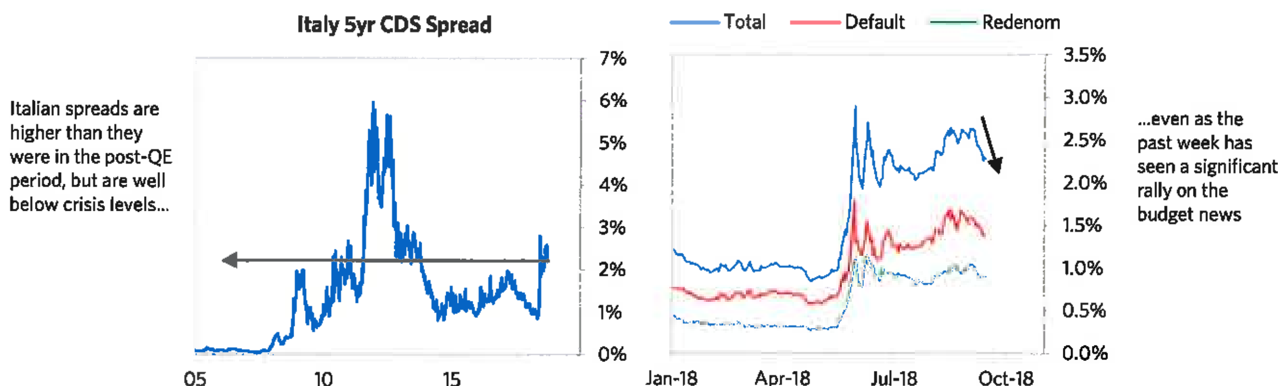
Italy Is Stuck

Jason Rotenberg | Paul Pasciucco

Last week, the Italian government and the EU made positive comments about their budget impasse, leading to a rally in spreads of about 40 basis points. While it looks less likely that there will be an immediate confrontation between the EU and Italy, the whole episode highlights the structural issues Italy faces and how limited their range of options is within the EU structure. Italy needs more stimulation (monetary or fiscal) but isn't likely to get it. The widening in spreads following the last Italian election combined with a less favorable global backdrop will translate into an even slower pace of recovery and another leg up in debt levels and debt service. The other path to a potential recovery could be meaningful structural reforms, leading to increased competitiveness and likely lower spreads, but that also seems impossible given domestic politics that now strongly favor antiestablishment parties. Italy doesn't have much bargaining power in a confrontation within the euro system because this leads to wider spreads, forcing Italian politicians to back down from their most extreme demands. This dilemma was summed up by the Italian Finance Minister, Giovanni Tria, on Sunday: "It makes no sense to seek two or three billion euros of extra deficit if we then have to pay three or four billion more due to higher yields." In short, Italy doesn't look to be on a sustainable path economically or financially, and as a result it remains the key challenge for the monetary union. These challenges will get materially worse the next time the economy faces a new downturn. The charts below show the current level of the CDS spread and our estimate of how that breaks down into default and redenomination risk. This pricing remains elevated relative to earlier in the year and is consistent with roughly a 15% probability of default or redenomination over the next five years.



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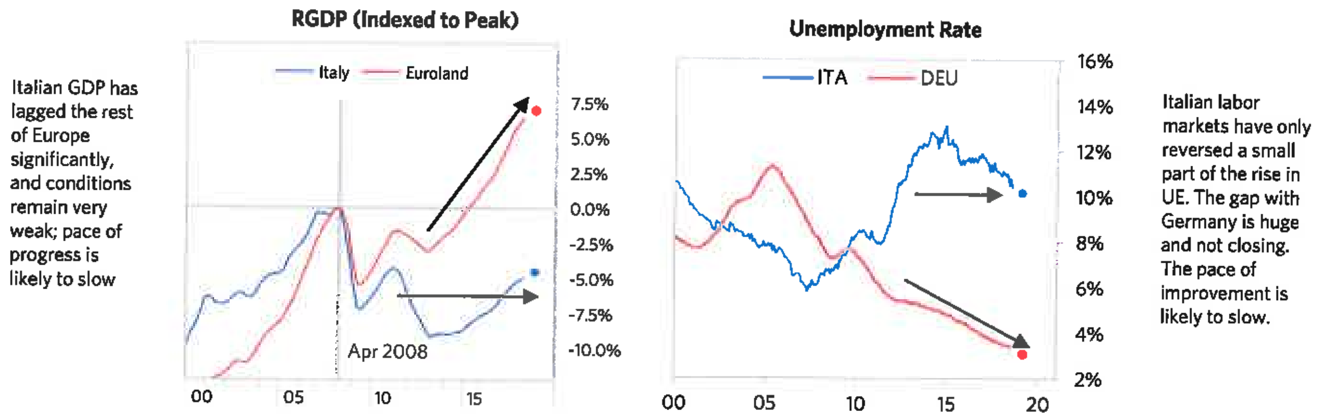
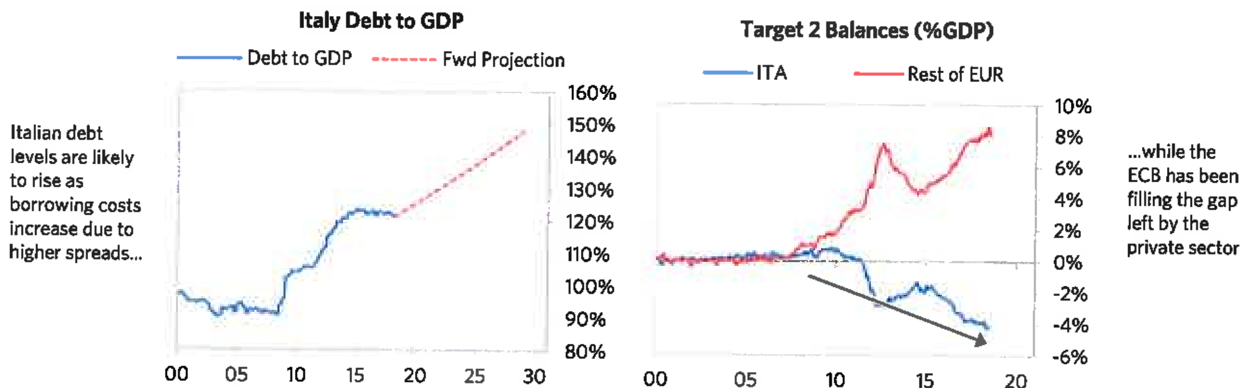
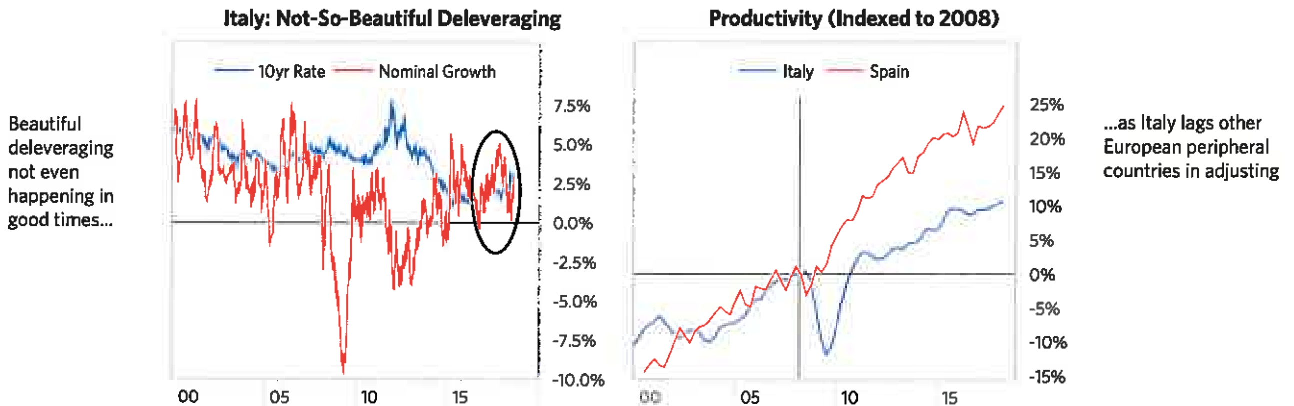
The dilemma is illustrated in the charts below: as you can see, Italy's economy is secularly depressed. The pace of progress has been very slow and is likely to slow further as a result of widening spreads (which unless reversed will gradually flow through to domestic borrowers) and less supportive global conditions. One potential support is fiscal expansion, but that would be in violation of EU rules and could be impossible either due to EU or market resistance (which would likely be related). And the gap between the level of Italian conditions and the rest of Europe is an issue for the ECB, as the policy that makes sense for Europe could push Italy into a more unsustainable situation. This can be seen clearly in the different labor markets of Italy and Germany, where the difference in recovery has been stark.



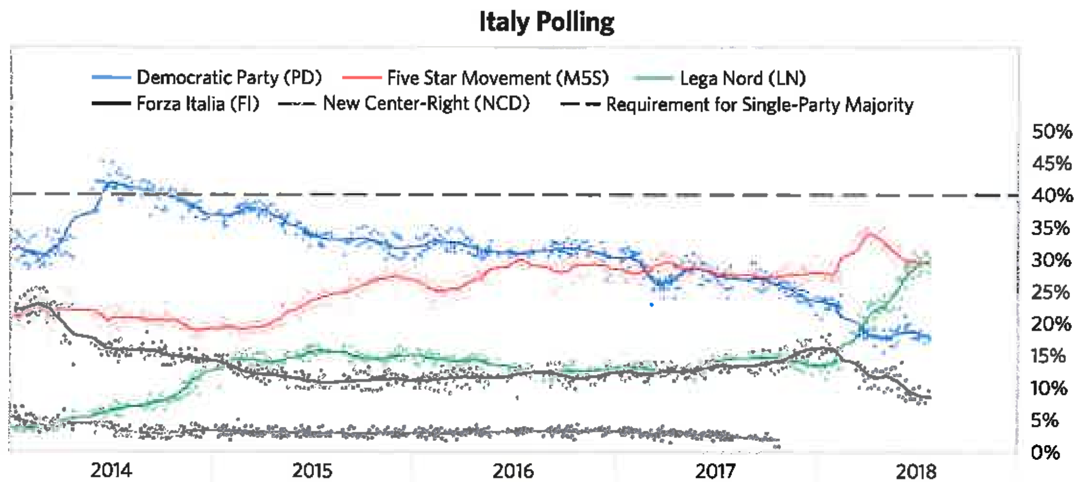
Even without fiscal expansion, Italy's debt situation remains a big problem. The charts below highlight the challenging longer-term problem that Italy is facing. Even before accounting for an increasing government deficit, Italy's indebtedness will continue to rise due to its already high debts and wider spreads, its structurally uncompetitive economy, and its inability to print or inflate away the debt. This is occurring at a time when the private sector appetite for Italian debt continues to decline. For the moment, the ECB has filled the gap, which is illustrated by the growing Target 2 balances.



Italy faces the tightest monetary conditions in Europe with the most depressed economy. This is preventing a meaningful deleveraging and leaving them unable to reduce their debts. And this is happening in strong economic circumstances, which raises the question of how Italy can handle the tightening of liquidity and a potential global slowdown. This, along with slow productivity gains and a lack of moves to improve the competitiveness of Italy, makes it difficult to see how growth could be sufficient to handle Italy's high debt load without some form of progress.



The Italian electorate has been and remains extremely fragmented, making it extremely challenging for any party or coalition of parties to push through the tough reform measures necessary to address Italy's long-term structural issues. So, there has been little progress. The rise of the populist coalition simply reflects these pressures, and without economic recovery, the political turmoil is likely to increase rather than decrease. Populist parties now have a commanding majority of support.



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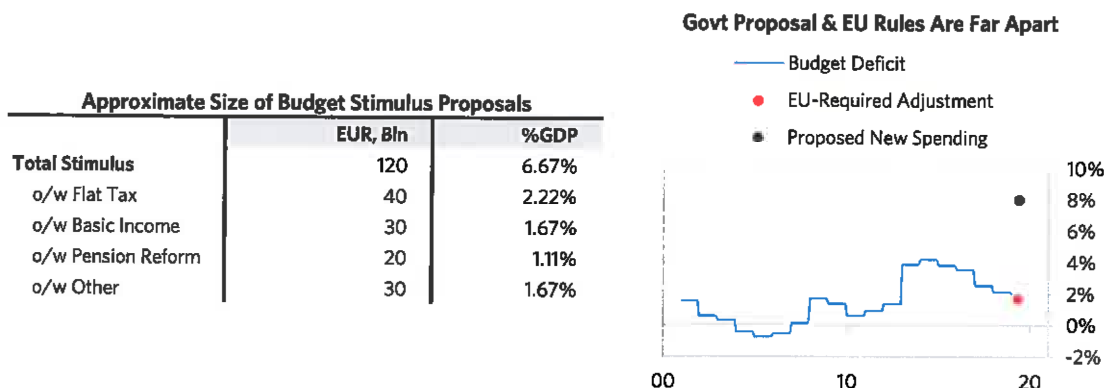
The new populist government has a mandate for economic improvement. Consistent with this, their proposed budget seeks to stimulate the economy through a variety of measures that reflect the ideological split between the Five Star and Lega parties. There is an attempt both to expand government welfare programs, like ensuring a basic income floor (from the left), as well as to reduce personal and corporate taxes (from the right). We believe they are likely to get something like 20% of the relief that they ask for, as Europe will give in only slightly to accommodate the harsh domestic conditions in Italy. This would have a budget impact of 0.5% to 1% of GDP, and wouldn't meaningfully change the longer-term picture of economic conditions or debt sustainability.



Approximate Size of Budget Stimulus Proposals

	EUR, Bln	%GDP
Total Stimulus	120	6.67%
o/w Flat Tax	40	2.22%
o/w Basic Income	30	1.67%
o/w Pension Reform	20	1.11%
o/w Other	30	1.67%

As we continue to watch the situation, there are two major deadlines in the next month. We broadly believe that the outline of a deal has been worked out, but these are milestones we will be watching. These deadlines and the details are listed below.

- *September 27 - Document of Economics and Finance (DEF)*: The DEF is a multi-year economic financial planning document that the Italian government must submit to the European Commission to demonstrate progress on closing the government's fiscal deficit and reducing the debt-to-GDP ratio under the Stability and Growth Pact. This will be an important signaling mechanism for how the newly elected government will manage to push campaign rhetoric into economic planning.

- *October 15 - Deadline for Draft Budgetary Plan Submission to the EU*: By October 15 of every year, member states submit a draft budgetary plan for the upcoming year to the Commission and the Eurogroup. The document must indicate the targeted budget balance and projections for expenditure and revenue. The Draft Budgetary Plan also contains the methodology, economic models and assumptions, and any other relevant parameters underpinning the budgetary forecasts and the estimated impact of aggregated budgetary measures on economic growth. The Italian budget submission to the EU could be a flash point between an M5S-Lega government and the Commission if differences are not resolved beforehand.

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