AEGON Asset Management

THE INFLATION EXPERIENCE: PART 2

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Prices: The macro perspective

As part of the Federal Reserve's statutory mandate, price stability receives a substantial amount of scrutiny. Based on the Fed's preferred inflation measure—core PCE*—annual price level growth has persistently remained below the Fed's 2% objective. This underwhelming inflationary environment exists alongside a steadily tightening labor market, which despite anemic wage gains has spurred the Fed to embark on a gradual monetary policy tightening. They are trying to strike a fine balance—premature tightening may constrain economic performance while a tardy response to a surge in inflation could abruptly tighten financial conditions and precipitate an economic slowdown. Furthermore, changes in inflation and inflation expectations, which are in part based on investor confidence in the Fed's ability to execute on this crucial mandate, impact returns across asset classes.

We are mindful of the transitory factors in items—namely shelter, wireless services prices, and healthcare—that have pressured core inflation lower, and will continue to do so over the near term. The recent quality adjustment to the wireless services category itself raises the specter of potential future changes to data methodology as the role of technology in production, wages, and spending requires deeper and more frequent statistical revisions. For now, however, absent measurement certainty, our discussion will focus on the cyclical and structural drivers of medium and longer term inflation.

Monthly and quarterly statistics can be noisy, so focusing on longer time horizons can better isolate the persistent engines of inflation, and help us to understand how to position when the cyclical collides with the structural.

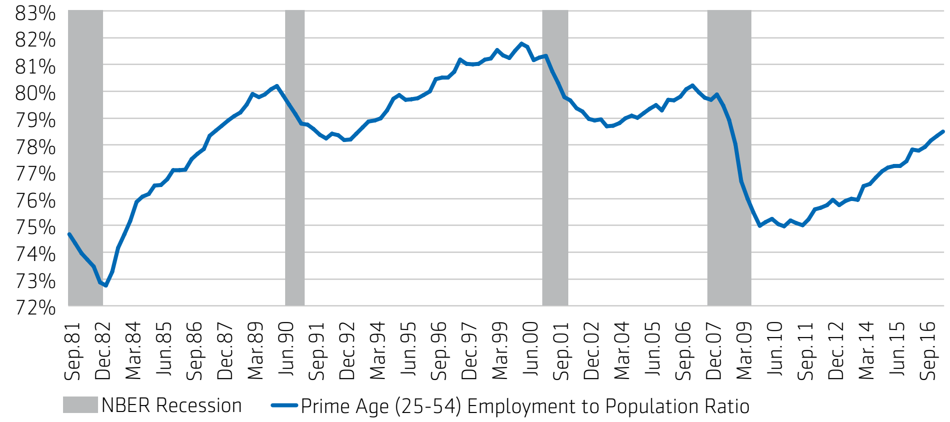
The Cyclical

Wages, a commonly used gauge of ensuing inflation, have not accelerated in line with improvements in the labor market. As of October 2017, the headline unemployment rate was 4.1%. Counterintuitively, rising employment has been matched by a decrease in earnings growth of the same magnitude (measured by the year-over-year change in average hourly earnings).

Originated in late 1950s, the Phillips Curve has been a commonly used tool to understand the direction and magnitude of changes in inflation at different points in economic cycles. In short, it observes measures of capacity utilization such as the unemployment rate relative to its structural value, or the output gap. The relationship between inflation and utilization is not always perfect. The 1970s stagflation flipped the relationship on its head, and even now the relationship appears to have softened in this recovery, prompting discussions on the model's relevance. Rather than question the effectiveness of the seemingly flatter Phillips curve, we discuss macro measures of resource usage that may belie seemingly ripe measures of capacity utilization, and may partly explain the relative lack of wage and inflation pressures.

*Core PCE in this context refers to the annual change in the price index for personal consumption expenditures, less food and energy components.

Exhibit 1: Prime-age workers underemployed

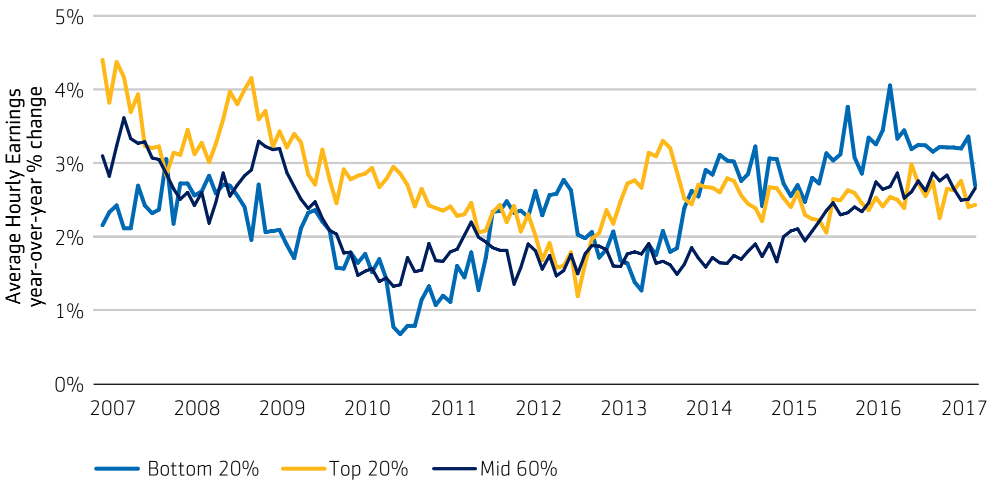


Source: NBER, Aegon AM US Macro Strategy, As of Q1 2017

Shifting Composition: Population

In a recent macro note, we estimated that the shifting composition of the civilian population has biased the unemployment rate lower by about 40 basis points, signaling further room for the labor market to tighten. That conclusion is further supported by a closer look at prime age workers, the single largest cohort in both the population and the labor force. As Exhibit 1 shows, those aged 25-54 have yet to reach normalized employment levels consistent with peaks in the prior three cycles.

Exhibit 2: Wage growth for high, medium, and low-paying industries



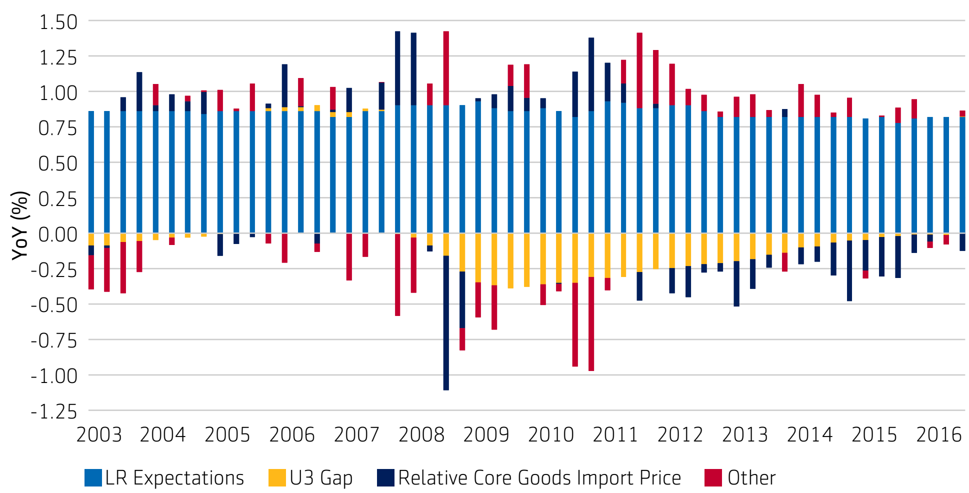
Source: Aegon AM US Macro Strategy, BLS, Haver Analytics, As of June 2017
Note: We've taken the BLS industry classifications in the average hourly earnings calculations, and grouped them into three categories based on earnings: the 20% of industries with the lowest employee-weighted hourly earnings, the 20% of industries with the highest employee-weighted earnings, and the remaining 60%.

Shifting Composition: Industry

Post-crisis private sector employment and wage trends deserve a closer look. Despite a recent dip in wage growth, courtesy of food and beverages stores, only the worst-paying industries (the bottom 20%), including restaurants and various retailers, have reached pre-crisis levels of employee-weighted wage growth. The mid 60% and top 20% of industries, however, have yet to grow wages at pre-crisis rates, thus delaying the return to pre-crisis momentum in aggregate wage growth.

A closer look at specific industries within each of the three clusters as of June 2017 is revealing. Since the crisis, the restaurant industry (bottom 20%) had job gains of about 2.3 million since June 2009. Administrative and support, and ambulatory services (middle 60%) had job gains of roughly 2.1 million and 1.5 million, respectively. Professional and technical services added close to 1.7 million jobs. These sectors are by far the largest job gainers in their respective clusters and, collectively, they have absorbed roughly 50% of the 15 million jobs added since June 2009. Wage growth in each of these industries, however, though broadly trending up, still remains materially below pre-crisis momentum, and even below post-crisis peak levels for some. The broad migration of jobs from the goods sector, where productivity gains are more prevalent, to the services sector, which experiences less productivity gains, exerts downward pressure on wage growth and inflation, all else equal.

Exhibit 3: Contributions to Core PCE



Source: Aegon AM US Macro Strategy, BEA, BLS, CBO, Philadelphia Federal Reserve Bank
As of 2016

Dealing with the Dollar

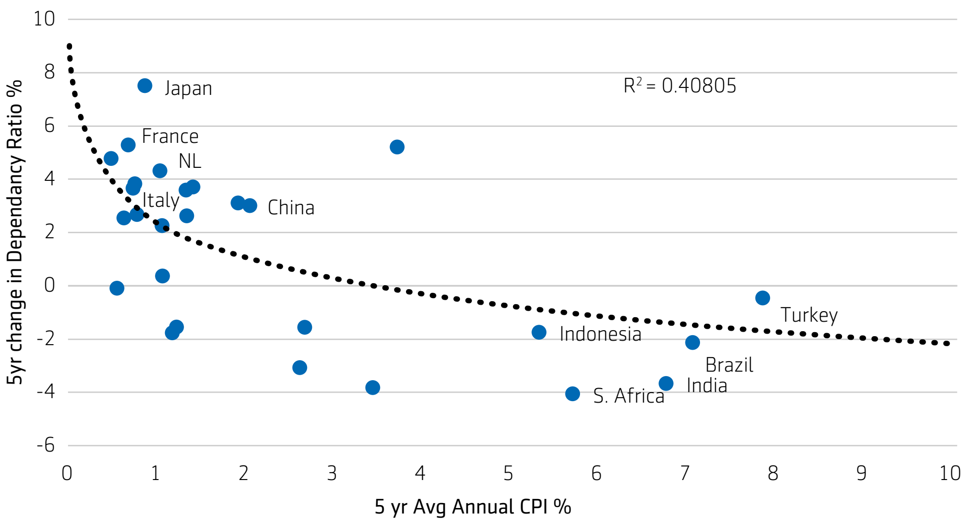
The US dollar's strength, from mid-2014 through 2016 in particular, has had a material impact on the relatively more volatile goods inflation via lower import prices. The Fed has recently estimated that a 10% real rise in the dollar could depress core goods import prices by as much as 3% per year, and core PCE by roughly 30 basis points, an effect that may persist for years absent corrections in GDP or monetary policy responses. Broadly in line with Chair Yellen's expectations-augmented Phillips Curve approach, which relates core inflation to transitory and cyclical deviations from a long run trend, we have decomposed the marginal contributors to core PCE sequentially, for a better read on inflation dynamics.

Exhibit 3 illustrates the persistent and downward effect a strong dollar regime has on core import prices, which in turn feeds through to inflation. As dollar strength eases and import prices recover, which is our medium term view, core inflation can be expected to inch higher as transitory effects dissipate. Just as importantly, the steadily improving labor market has progressively reduced the downward influence of labor slack on core inflation levels (yellow bars). With long term inflation expectations relatively steady, the marginal contribution from further reductions in labor slack may be expected to flow through core inflation as the currency effect stabilizes. Risks of a material upside contribution to inflation are low, as core inflation is least sensitive to labor slack in this approach, and unemployment would need to fall materially below its currently estimated natural rate.

The Impact of Autos

Recently, Aegon's research team concluded that auto prices may have reached a cyclical peak, and that a likely surge in auto supply will pressure auto prices lower in the medium term. While the potential effect on core inflation would be temporary, new and used vehicles represent roughly 3% of consumption expenditures and do tend to show cyclical influences on spending and inflation.

Exhibit 4: Demographics drives inflation



Source: IMF, World Bank, Aegon AM US Macro Strategy, As of 2016

The Structural

We've previously opined on the trajectory of global long run inflation, as structural influences suggest that inflation will remain muted longer term. Demographics are one such structural pull in the US, and outside the purview of the Fed, as the aging population pressures inflation lower. Exhibit 4 highlights that effect. An increasing dependency ratio, as the population aged below 15 and above 64 increases relative to those aged 15-64, pulls inflation lower, presumably via lower aggregate expenditures and demand for commodities. A structural decline in population growth, as suggested by the BLS, adds to that effect.

Conclusion

While the balance of transitory and cyclical influences suggest upward pressures on inflation in the medium term, structural factors suggest that inflation should remain muted. Core inflation of 2% may be more of a ceiling than a symmetrical target, as reflected in our longer term outlook for inflation. This mirrors our outlook on sustainable economic growth, which we believe has shifted lower.

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