Right now inflation is the most important macro indicator

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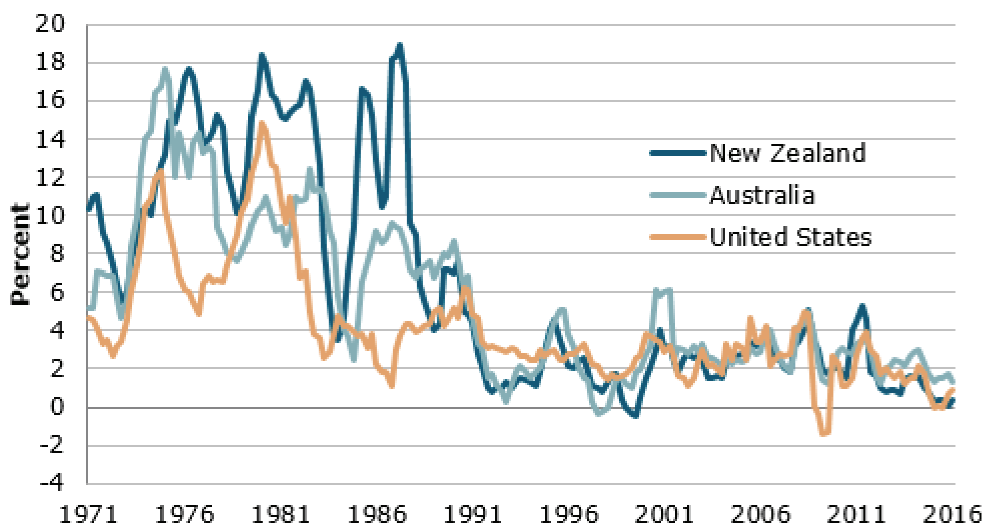
Central bankers are facing uncharted territory. Having successfully tamed inflation in the late 1980s and early 1990s, inflation became so well anchored around 2% through the 1990s and 2000s that it fell off the radar of investors. Instead, markets focused on the economic cycle as an indicator of central bank actions. However, with persistently low inflation the new problem, right now inflation should be the most important macro indicator on the radar of investors.

In economic history, the 1970s and 1980s stand out for high and variable inflation that stifled economic activity and scared financial markets. This was a global phenomenon, which prompted a widespread shift to inflation targeting in the late 1980s and early 1990s. While the Reserve Bank of New Zealand (RBNZ) was a pioneer, it was really a global effort across developed countries that successfully tamed inflation to settle around 2% for much of the next 20 years (Figure 1).

Figure 1: Annual CPI Inflation



Source: Bloomberg

Indeed, central banks were so successful at inflation targeting that traditional economic relationships began to breakdown. Historically, the so-called Phillips Curve captured a negative relationship between inflation and unemployment – that is, when the unemployment rate fell and labour markets became tighter, this lack of spare capacity pushed up wages and CPI inflation. However, with inflation expectations so well anchored

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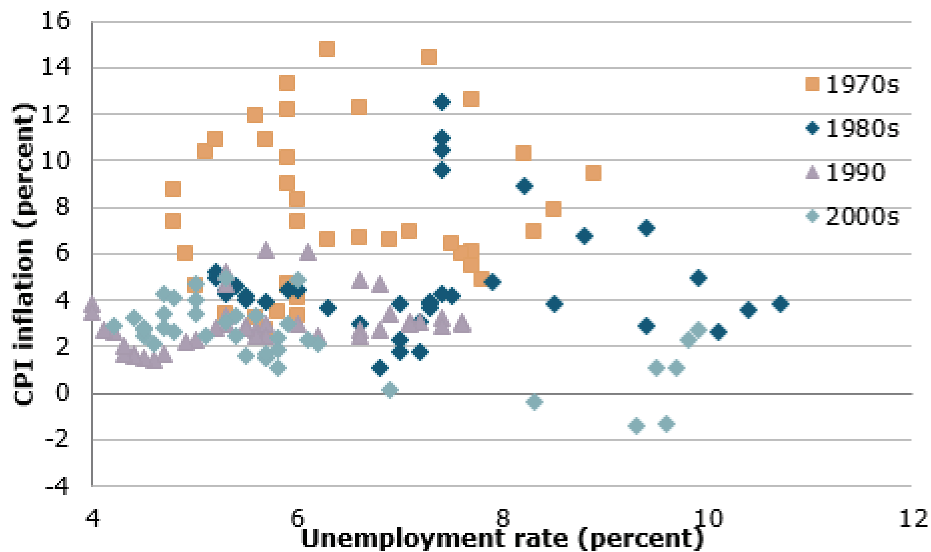
since the 1990s, the Phillips Curve had become flat, with CPI inflation almost completely insensitive to state of economic activity (Figure 2).

Figure 2: The US Phillips Curve – inflation vs unemployment



Source: Bloomberg. Quarterly data.

With inflation expectations so firmly anchored around inflation targets, through the 1990s and 2000s, CPI inflation outturns were relegated to secondary importance by the market. In that environment it made much more sense for bond and equity markets to focus on leading indicators of economic activity. The primary role of central banks through that period had simply evolved to "leaning against the wind" of the economic cycle to smooth out any remaining inflationary pressures. US payrolls number became the biggest data release of each month, and other leading indicators such as the ISM manufacturing survey captured the attention of markets. This was mirrored in other developed economies.

However, in recent years central banks and markets have entered unchartered territory. The new problem they face is not fighting inflation, but persistently low inflation stuck stubbornly below targets. While this has been a global theme, the issue is nicely illustrated by the RBNZ's inflation forecasts versus actual outturns (Figure 3). There are a number of structural factors that in part explain this period of low inflation – falling energy prices, deleveraging, demographics, and technological change – but none of these capture the full picture. It appears that the traditional macroeconomic models used to understand economies have broken down.

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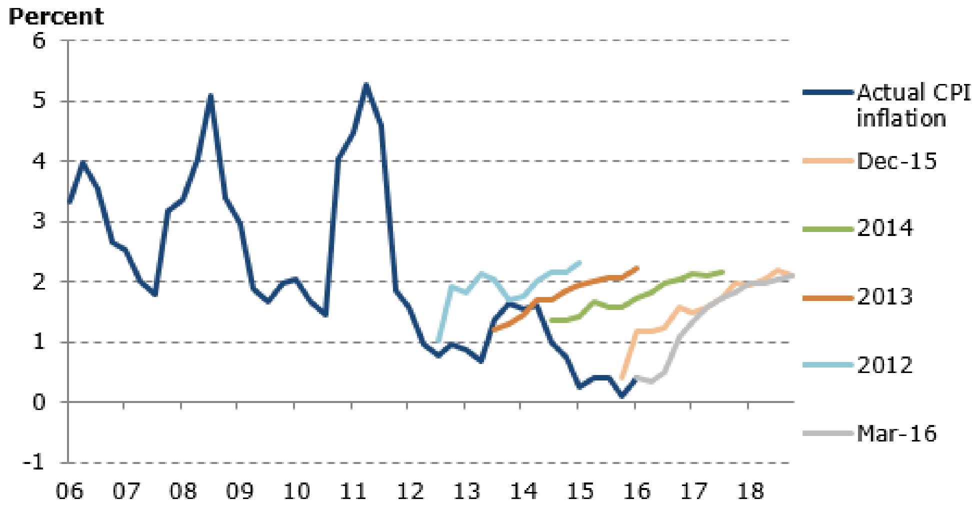
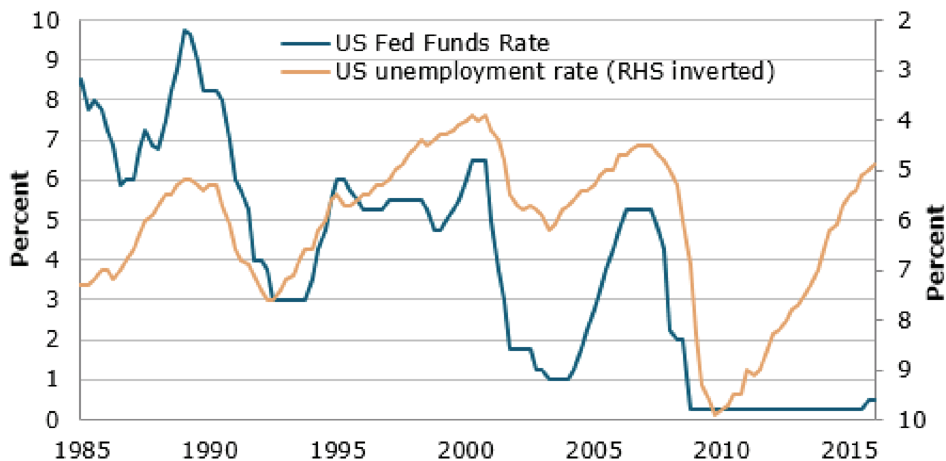
Figure 3: NZ inflation versus RBNZ forecasts



Source: Bloomberg. Quarterly data.

With traditional economic relationships no longer holding, the behaviour of central banks has also changed. For over the 30 years before the Global Financial Crisis, the unemployment rate was a very reliable indicators of central bank actions (Figure 4). For example, until 2010, there was very high contemporaneous correlation between the US employment rate and US Fed Funds Rate. However, since, the US employment rate has fallen from 10% to below 5% with almost no change in the US Fed Funds Rates. The reason is that the US Federal Reserve has not seen sufficient inflation pressures building to take action. If anything, central banks have lost confidence that the long awaited rise in inflation back to target is around the corner. For now, they remain more fearful of deflation than inflation.

Figure 4: US unemployment rate versus US Fed Funds Rate



Source: Bloomberg.

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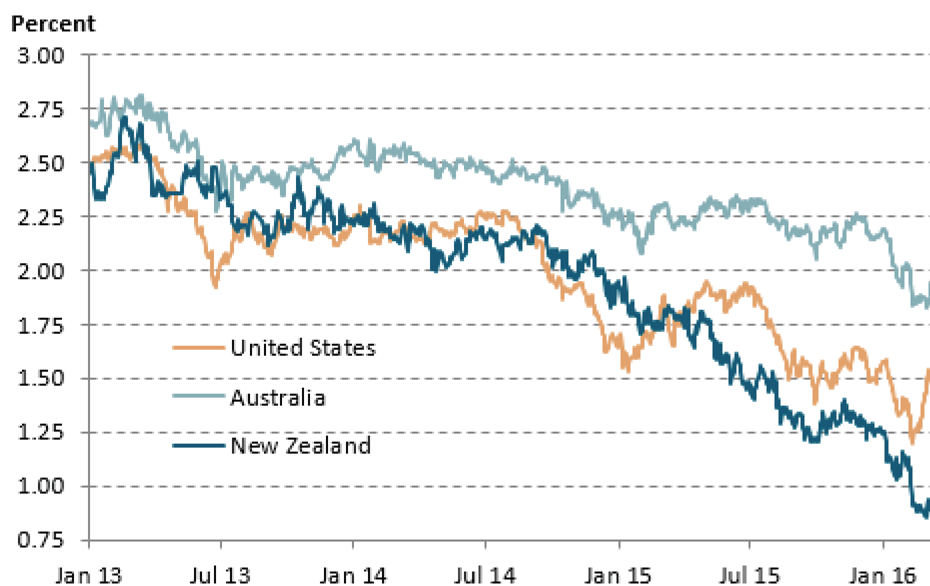
With heightened uncertainty about traditional relationships, central banks are being forced to wait until they see actual inflation rising before they start removing monetary stimulus. This in itself is a delicate strategy to follow. It takes time for monetary policy settings to affect inflation. So, when inflation arrives, there is likely to be more in the pipeline. The danger for markets is that they could be too complacent about the outlook for inflation. Inflation indexed-linked markets suggest that the market is expecting inflation to sit below central bank targets for considerable time (Figure 5). This makes markets vulnerable to an inflation scare if and when theses pressure do eventually re-emerge.

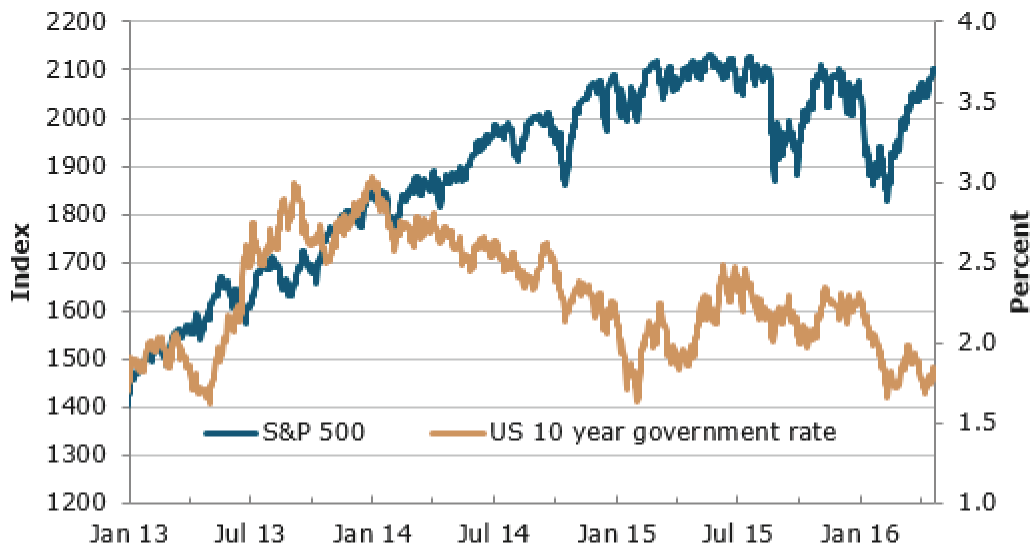
Figure 5: Market expectations of CPI inflation (10-year implied inflation breakevens)



Source: Bloomberg.

So we have moved into a period where the outlook for inflation has become critical not only for fixed interest markets, but also all other markets underpinned by stimulatory monetary policy. Since the beginning of 2014, global bond and equity markets have appeared to diverge, as bond markets have priced-in a gloomy outlook for activity and inflation, while equity markets have been buoyed in part by the prospect of that outlook resulting in continued central bank support (Figure 6).

Figure 6: US equities versus US 10-year government bond yields



Source: Bloomberg.

A rise in inflation that is supportive of company earnings could be positive for equities. However, an inflation scare that forced the hand of the US Fed to tighten policy quickly could hurt bond and equity investors alike. For that reason, leading indicators of inflation should be just as important on the radar of equity investors.

In conclusion, central bankers are facing uncharted territory. Persistently low inflation is the new problem, and deflation is the fear that has gripped markets and central bankers. Old relationships between economic activity and inflation seem to have broken down, and dented the confidence of central bankers to act pre-emptively.

Rather, it looks like monetary policy will remain highly stimulatory until central banks see definite evidence that inflation is rising and better anchored around 2%. It is not our central view that high inflation will emerge as a problem. However, with markets complacent about the inflation outlook, signs of inflation could create at the very least a temporary scare.

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