Infomail

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Economics 101

(Will Inflation Rear Its Head in 2018?)

For the past nine years, every major central bank in the World has been priming the pump with monetary stimulus in a concerted effort to prevent a deflationary environment from taking hold after the Great Recession of 2008-09.

As balance sheets were deleveraged around the World, the biggest fear was a post-1989 Japan scenario began to unfold.

The most interesting observation was how all this stimulus in all of its various forms (low rates, quantitative easing, negative rates, purchasing of assets, etc. …) has not created a single sniff of inflation. In fact, most inflation numbers remain below central bank targets.

Economics 101 has failed.

While there are many reasons which can be put forward, they include:

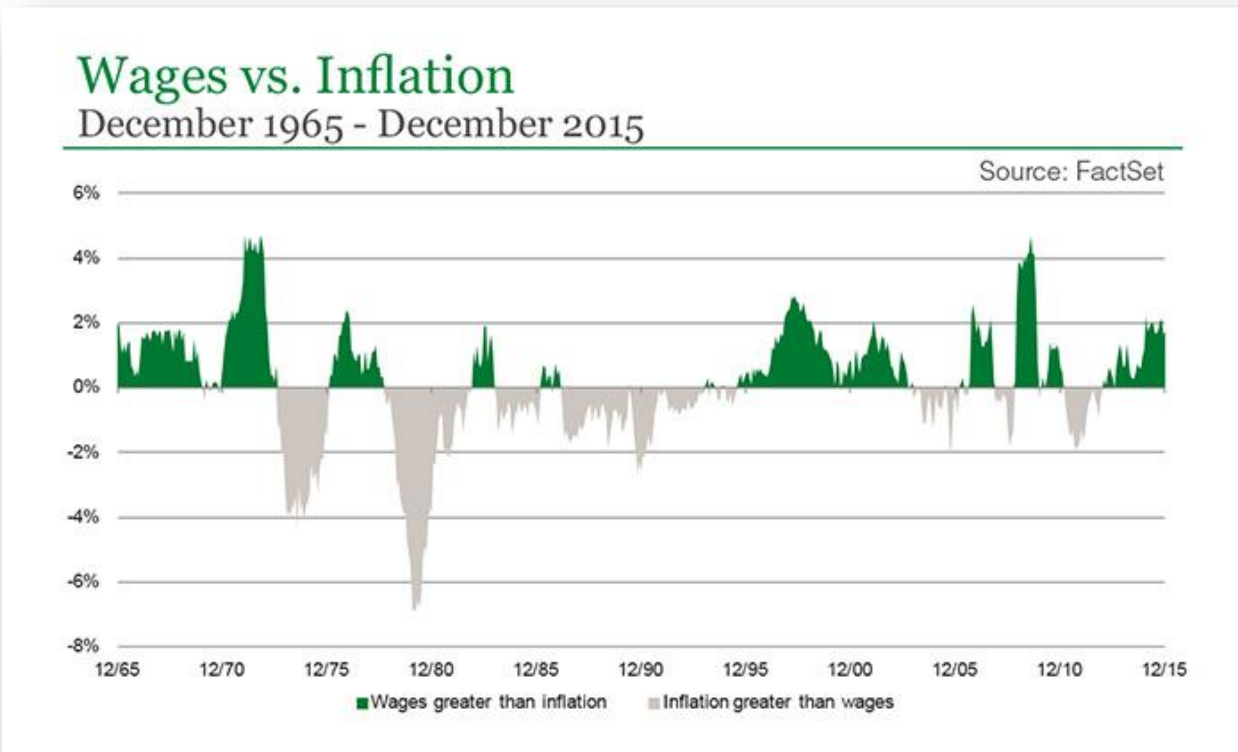
- The huge impact of technology
- Increased productivity gains
- Demographics
- The impact of lower wages than most down cycles
- Reduced velocity of money as banks hoarded deposits
- The reported numbers don’t reflect reality

But that may be about to change…

The USA’s unemployment recently docked in at 4.20%, the lowest in history. And one thing Economics 101 preached, is there was a strong correlation between low unemployment rate, and rising inflation.

The concept is simple:

- Unemployment gets to the low levels as economies improve
- The supply/demand equation (i.e. competition for labour)pushes wages higher
- Higher wages equal higher costs for employers
- Higher costs get passed on via higher prices
- Inflation kicks in



Note (for above) – With real wage growth (seen in green) you can see a lag period where inflation kicks in, outpacing wage growth (seen in grey).

The last three times the unemployment rate got this low, inflation started to tick up. This could explain why the Federal Reserve in the USA and the Bank of Canada have begun to raise rates when an argument can be made that both economies are not at that point of strength in the economic cycle. Maybe they know/see something others don’t?

Remember, if central banks move rates higher too quickly in anticipation of coming inflation, there comes a tipping point down the road that pushes the economy into recession. The last three recessions were all caused when higher rates burst "bubbles":

- The housing bubble in 2008-09
- The "Dot-com" bubble of 2000-01
- The savings and loan bubble in the early 1990's

The global labour market is changing quickly. There is usually a lag between low unemployment and rising wages, but the US economy, Europe, and the Emerging Market economies seen to be ramping up quickly, and cycles seem to be moving faster than in the past.

The equites markets seen to be tipping their hand as well, as many commodity prices, across all sectors, have been breaking out. Material and cyclical names are catching bids for the first time in a long time.

If this scenario continues to play out, look for the Canadian market to be one of the better performers because of our over-exposure to the commodities and cyclical sectors.

As always, we will continue to monitor the progress and will make adjustments in our portfolios as required.

Stay tuned,

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