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Chief economist's comment

What does inflation mean for you?

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Paul Donovan, Global Chief Economist WM, paul.donovan@ubs.com

- Inflation will likely increase in most developed economies in 2017.
- There will still be differences in inflation between different economies, depending on local labor market conditions.
- Price rises are concentrated in certain sectors, meaning equity markets may not be the best inflation hedge. Higher-income consumers will generally experience lower inflation than most.

Inflation is back. Actually, inflation never went away. The world has been living in an inflation illusion over the past couple of years. Low crude oil prices dragged down headline inflation rates. Crude oil is not directly part of consumer price inflation; pouring a barrel of crude oil into the engine of your car will have very adverse consequences. However, consumers buy gasoline (refined crude oil), airline tickets (about 40% of the price represents the cost of aviation fuel), and food (delivered to supermarkets by trucks that use diesel). The prices of gasoline, airline tickets, and food are in consumer price inflation. These prices are influenced by the price of crude oil because crude oil is embedded in their costs.

Crude oil generates about 5% of the consumer price basket in a developed economy, once one digs beneath the surface. Crude oil generates around 3% of the consumer price baskets that "exclude" food and energy, because air fares and similar prices are still included in those measures. In recent years, the price of crude oil fell about 75% from peak to trough. A 75% price fall obviously impacts the headline inflation rate.

If oil generates 5% of the consumer price inflation basket, what makes up the rest? Domestic labor costs typically generate 70% of the consumer price inflation basket of a developed economy. That is obvious for the price of a service; legal fees are nearly all labor costs. However, domestic labor costs dominate most prices including imported goods prices. The price of an import arriving in a country is further increased by the costs of the local shop assistant, the advertising executive, the truck driver, and so forth – all domestic labor costs.

As some labor markets have strengthened, employees have started to demand higher wages. Skilled labor has been particularly able to obtain pay increases in certain economies. As labor costs rise, firms either have to accept a lower profit margin or must attempt to pass on those higher labor costs to their customers by raising prices.

Now that oil prices have stopped falling, the inflation pressures from wage costs are more obvious. The return of inflation is not straightforward, however. There are three complications that investors need to consider.

1. Where you are matters

Domestic labor costs are created by domestic economic circumstances. Domestic labor costs dominate the composition of inflation in normal times. Therefore, inflation is a local issue. This truism helps explain why Venezuela had hyperinflation at exactly the same time as Switzerland had deflation.

The ending of the oil impact on inflation is a global experience. The extent to which other factors now add to higher inflation will depend on local circumstances. Economies like Germany and the United States, with faster wage pressures, are likely to experience higher inflation. Economies like Greece, with relatively slow wage pressures, are likely to experience limited increases in inflation.

2. Equities are not inflation-proof

Not all prices rise at the same pace. Not all companies listed on equity markets have the same pricing power. Thus, not all equities serve as a hedge against inflation.

Few companies sell to consumers. Most companies sell to other companies. In most cases, it is producer prices and not consumer prices that are the more relevant indicator for corporate pricing power (one obvious exception is the retail sector). If taxes or tariffs raise consumer prices, that is unlikely to signal higher earnings for companies that sell to other companies.

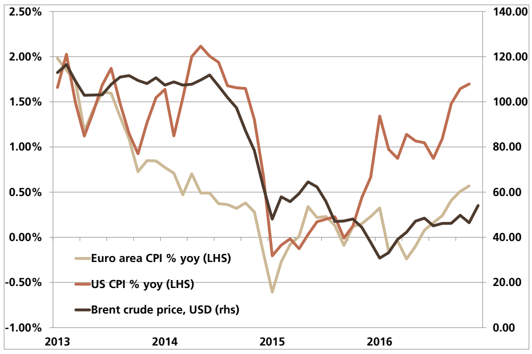
Inflation is also focused by sector. Housing, healthcare, and education are around 45% of the US consumer price inflation measure. These sectors have a far lower weight in the US equity market. Indeed, the rising price of housing, healthcare, and education may leave consumers with less income to spend on other products. Pricing power in healthcare could mean reduced spending on leisure, for example. Leisure sector stocks would not hedge healthcare inflation.

3. Who you are matters

Different consumers buy different things. The spending pattern of the elderly is very different to that of the young. The spending pattern of higher-income groups is very different to that of lower-income groups. Average inflation measures almost certainly do not reflect personal inflation experiences. Generally, the inflation rates experienced by the lower-income or the older consumer are higher than average; it is cheaper to be young and rich if you can possibly manage it.

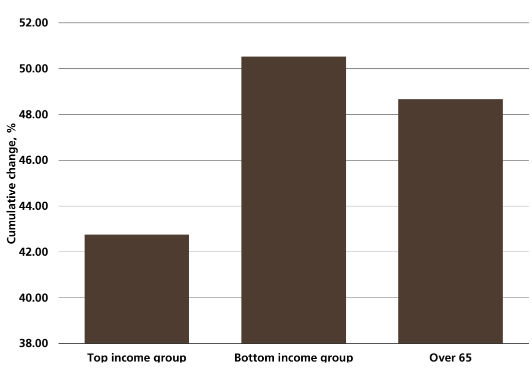
This inflation inequality may have political implications. Lower income groups "left behind" by economic prosperity may feel that their standard of living is not improving if inflation inequality continues. If policies like trade protectionism disproportionately increase the prices of goods purchased by lower-income groups, then the political populism could actually undermine the living standards of those that supported political populism in the first place.

US and European inflation and the price of oil



Source: Haver, UBS, as of 13 January 2017

Cumulative inflation for the US highest- and lowest-income groups and those over the age of 65, January 2000 to January 2016



Source: UBS calculations from BLS

Living with inflation

2017 is the year that inflation emerges from the shadow of the low oil price. Investors, rightly, need to consider what rising inflation indices mean for their portfolios. However, inflation is not a simplistic concept, and the nuances of inflation may be the most interesting aspect as the world returns to the old normal of more rapidly rising prices.

Appendix

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