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# Chief economist's comment

## A.I. – After Inflation. Now what?

**Chief Investment Office WM | 17 May 2017**
**Paul Donovan**, Global Chief Economist WM, paul.donovan@ubs.com


- What comes after the recent inflation? More inflation.
- The rise in developed economy inflation, to rates at or above long-term averages, was obvious. Now that oil base effects have come through, a different sort of inflation emerges.
- Investors need to focus on local drivers of inflation, especially the labor market. Away from the oil price, inflation is a local phenomenon.
- Investors should make sure they are looking at the right price measure. Corporate pricing power is shown by producer not consumer price inflation. Bond markets and central banks may focus on different inflation measures.
- Changing inflation does not mean that prices have to change. There are technical factors in inflation calculation that can give a misleading idea of what is happening to prices in the economy.


## A.I. – After inflation

What comes after the recent inflation? More inflation – but of a less obvious, more subtle sort. Investors will have to work harder to understand the nature of the inflation we are now facing.

In 2015 and 2016, there was a weirdly dramatic decline in oil prices. Oil is between 3% and 5% of most countries' consumer price inflation baskets – not a huge part of the total. However, if the price of even 3% of an inflation basket falls 75% over two years, the headline inflation rate is bound to be affected. The resulting low inflation rate produced a frenzy of ill-informed media speculation about a *deflation* threat.

Deflation only occurs when lots of prices are falling (and when it does occur, it is very worrying). The low inflation of 2015 and 2016 was all about just one price falling – the oil price. As soon as the oil price started to behave normally, it was obvious that headline inflation would behave normally. This is exactly what has happened. In the world's developed economies, consumer price inflation is now normal – or indeed higher than normal.

For investors, the rise in inflation in recent months has been an easy thing to predict and to protect against. The difficult question is what happens now? As the after-effects of the oil price decline end, investors need to become more subtle in considering inflation. Inflation is not going to disappear, but it is going to be different.

### Inflation is around normal

What is the starting point for thinking about inflation? In most developed economies, inflation is about normal. Fig. 1 compares US inflation rates with their 20-year averages. Both the consumer price inflation measure favored by financial markets and the personal consumer expenditure deflator favored by the Federal Reserve are shown. This is not a low-inflation environment; it is a somewhat higher-than-normal inflation environment.

The euro area is a bit behind the United States. Inflation in the Eurozone has been increasing, but it is more in line with long-term averages. Fig. 2 compares Eurozone inflation with a 14-year average (the history is shorter because the euro has not existed for that long). There are fewer inflation statistics to choose from in the euro area, but they show an average inflation rate.

Investors need to remember that the low headline inflation of 2015 and 2016 was an oil-induced hallucination. Half the major OECD economies had core (ex food and energy) inflation at or above its long-run average in each of the two years. The reality of inflation today is that prices are behaving normally. There is no brave new world when it comes to inflation.

### Inflation is local

What is driving inflation? If oil is not swinging about wildly, inflation is largely driven by the domestic labor market. Domestic labor costs make up between 60% and 70% of the consumer price basket. Other commodities play a role, but their prices tend to lack the volatility exhibited by oil. This means in normal commodity market conditions it is capacity of the domestic economy that will have most significance for inflation. The US economy has been stronger for longer than the European economy, and so US inflation is above normal when it is in line with long-term averages in the euro area.

One clear way of seeing this potential divergence of inflation is by looking at the correlations of core consumer price inflation rates. If there were a global driver of inflation pressures, core inflation would be correlated between major economies. They are not. The correlation of core inflation rates between major economies, even between Eurozone economies, is generally very low.

Investors need to prepare for a subtle change in inflation, therefore. The last few months have seen an environment "all about inflation, in all the countries, all the time." That is not the case now. Inflation divergence presents investors with opportunities.

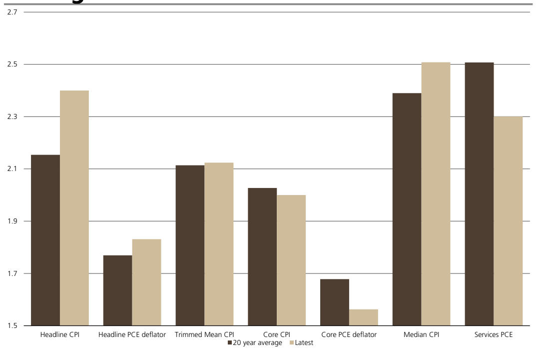
### Pay attention to the price measures that matter

All too often, the consumer price inflation measure is treated as if it were the only inflation measure that matters. Investors need to be a lot more sophisticated than that if they are to understand the risks to their portfolios.

For bond investors, the inflation rate central banks focus on and the inflation rate bond markets use are what matter. In the Eurozone, headline consumer price inflation is the mandated target of the European Central Bank. In the United Kingdom, it is also headline consumer price inflation. In the United States, however, the Federal Reserve looks at the personal consumer expenditure deflator – which is a very different and occasionally divergent measure from consumer price inflation.

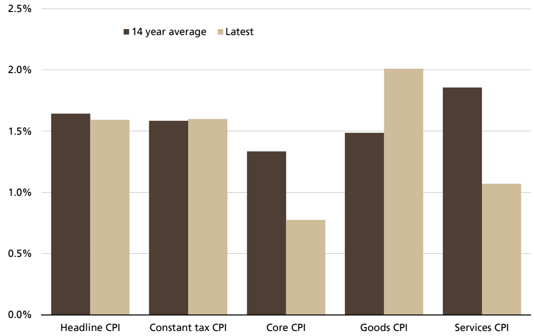
However, investors who seek to hedge inflation using inflation-protected securities may be tied to different inflation rates. The UK index-linked gilts

**Fig. 1: Current US inflation rates vs. 20-year averages**




Source: Haver, UBS, as of 10 May 2017

**Fig. 2: Current Eurozone inflation rates vs. 14-year averages**




Source: Haver, UBS, as of 10 May 2017

market references the retail price measure of inflation, which has a different composition and a different rate of change than consumer price inflation. While the Federal Reserve may pour over the personal consumer expenditure deflator, the US inflation-protected bonds reference the consumer price measure.

Equity investors need to look at different measures again. Most companies do not sell to consumers; most companies sell to other companies. Companies that sell to consumers make up a very minor part of the US S&P index (between 10% and 20%). It is the producer price inflation measure that is most appropriate as an indication of domestic pricing power. It is also worth bearing in mind that a company that sells its products internationally will have its pricing power determined by export price inflation as well.

In a world where all inflation rates are rising rapidly, consumers do not have to worry too much about these details; in a more normal inflation environment, understanding exactly which inflation rate matters to which asset is a lot more important.

**Inflation changes, prices don't have to**

Finally, investors do need to pay attention to why inflation rates are changing. Inflation can go up and down without prices changing. The inflation measure adjusts for quality and quantity. US mobile phone services have fallen in price in the consumer price basket recently, not because people are paying less money but because people are able to download more data for the same amount of money.

Why does that matter? If people are not paying less money, they may not feel any better off and they may not have any more money to spend on other goods or services. Nonetheless, the consumer price measure reports that prices have declined. Conversely, if a chocolate bar gets smaller without the price changing (sometimes called "shrinkflation"), the consumer price measure will rise.

**After Inflation – subtle inflation**

The rise of inflation at the start of this year was an easy forecast to make. Now that the inflation increase has largely occurred, investors have the more difficult task of understanding the subtle shifts in the different inflation rates that matter.

# Appendix

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