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CORPORATES & MARKETS

Economy

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US: should we fear a return of inflation?

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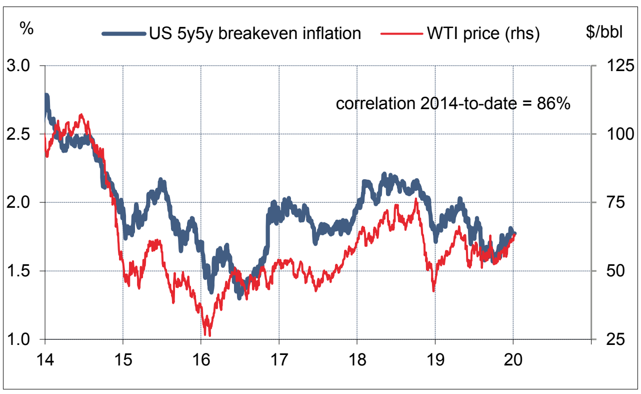
The risk of a slide back into recession was the major question of 2019. All told: this triggered more fear than damage. For 2020, will the change of theme not prompt investors to worry about a rebound in inflation? Inflationary forces remain contained in the US, but point upwards due to geopolitical tensions (oil risk), low unemployment (wage risk), further expansion of the Fed's balance sheet (monetary risk), trade war (tariff risk). In addition, what Donald Trump wants more than anything else is a weaker dollar. None of the above is likely to worry the Fed, however.

The week's focus

For the sixth time in seven years, US inflation will stand below the Fed's target rate in 2019. Generally speaking, inflation expectations for the medium term are not taking off. The markets' favourite metric, the breakeven point for 5Y5Y inflation, barely picked up since last summer, whilst in the intervening period, the probability of recession over the next 12 months has been revised sharply down (chart lhs).

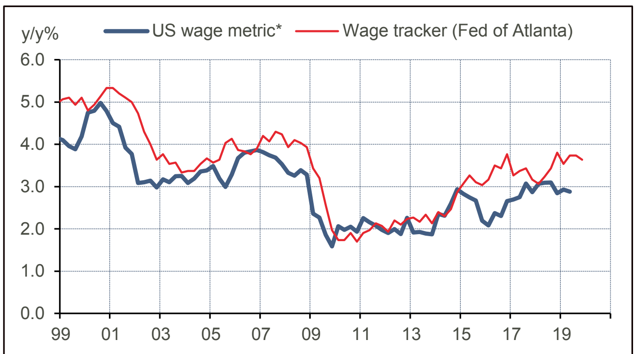
In the eleventh year of expansion, we would be justified in expecting higher inflation. According to the CBO, the output gap is now positive, to the tune of 0.7% of GDP. There may still be unused resources in the labour market, but they are tending to disappear. Once this is done (at the current rate, it may take another two to three years), wage growth could then come out of the top of the zone where it is trending. Wages are on a trend growth of about 3% per year, which is not excessive (chart rhs). Moreover, the recovery in wages seen since the end of the recession has not exceeded productivity gains and unit labour costs have not spiralled. There is every reason to think that the equilibrium employment rate has moved lower, which delays the moment when labour market strains are likely to emerge. The other possible sources of inflation remain contained. The tariff increases have had little impact on end prices. Oil prices are showing some volatility (see p.2) but are not on an upward trend. Last, we find it hard to believe that the Fed's resumption of purchases of government bonds will cause the dollar to plunge. Overall, inflation is likely to accelerate in 2020, lifting the rise in the PCE index towards the target of 2% (versus 1.4% in 2019). What would happen if the uptick were more marked? The Fed has a simple answer: nothing. After years of below-target inflation, the Fed has no problem letting it rise above the target. In short, even if inflation picks up, there is very little chance of monetary policy being tightened this year. The elections also make this unlikely.

US: breakeven inflation and oil prices



Sources: Thomson Reuters, Bloomberg, Oddo BHF Securities

US: wage metrics



* average of 8 wage or labour cost measure

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Economy

- Excluding residential construction, the investment cycle continued to struggle at the end of 2019. In **November,** orders for durable goods were down by 2% m-o-m, essentially due to the marked decline in military orders. Excluding these volatile elements, core orders were more or less stable. Non-residential construction spending was down by 1.2% m-o-m, showing just +0.2% y-o-y. In **December**, truck sales partially wiped out their sharp decline of the previous month (+7.6% after -12.3%). With regards to truck orders, these are on a downtrend which is set to continue. All of this augurs badly for the components making up investment in Q4 2019. According to the Atlanta Fed's nowcast, spending on equipment is expected to be down by 1.4% q-o-q on an annualised basis and non-residential investment is set to fall by -12.7%.
- In **December**, the Conference Board's household confidence index changed very little (-0.3 points), remaining at a high level. The employment conditions sub-index, which showed an unexpected fall the previous month, picked up (+2.3 after -4.5). Here again, the absolute level remains very high and points to no imminent deterioration in the labour market.
- The purchasing managers' confidence index remains difficult to read due to the disparity between sources. In **December**, the ISM-manufacturing index was down again (-0.9 points) close to its lowest point for the past ten years at 47.2. The gap is widening with the PMI Markit index (-0.2 points to 52.4) and regional manufacturing data (-1 point to 51.0). These differences could stem from the constitution of the panels. The ISM survey primarily focuses on large-scale businesses, thus potentially resulting in a greater sensitivity to recent specific shocks (Boeing, GM) and trade uncertainty. The signal is more coherent in the services sector: the ISM index gained 1.1 points to 55.0, the PMI index +1.2 points to 52.8 and the regional aggregate index +0.4 points to 55.7. All told, the synthetic confidence index for all sectors ended 2019 on an uptrend at 54.1 points, its highest level since July 2019.

Monetary, fiscal and trade policy

- There were fears of turbulence in the repo market towards the end of the year, but the catastrophe predicted by some parties did not happen. The Fed had taken the precaution of increasing the ceilings on its different operations in this market, ensuring that short rates would not come under pressure. On **8 January**, the Fed's liquidity injections with various maturities totalled $ 211bn vs $ 256bn at the very end of 2019.
- The tension between Iran and the US has increased significantly since the start of the year after the attack on the US embassy in Baghdad by pro-Iranian forces, and the assassination of an Iranian leader by US drones in return. The verbal escalation, which is the least costly, went very far, but actions were fortunately more moderate. Iran bombed US bases with no victims. President Trump has promised new economic sanctions. Each camp might leave matters there. These events caused the oil price to yo-yo, but the pressure did not last. The average WTI price for 2019 was $ 57 per barrel. It is currently at $ 59 per barrel, after a temporary surge to $ 66. This is a far cry from an oil shock.
- The official signing of "phase 1" of the trade agreement between the US and China is scheduled at the White House on **15 January**. President Trump will subsequently go to Beijing to launch talks on "phase 2". Tension is easing between the two countries.

The week ahead

- Several key statistics will be worth following: consumer prices (**14 January**), retail sales (**16**), industrial production and housing starts (**17**). The Fed's Beige Book (**15**) will provide a comprehensive view on the state of the US economy at the very end of 2019. CPI inflation might accelerate from 2.1% to 2.3% year-on-year in December, mainly due to comparison base effects in volatile items. Core inflation is expected to be stable at 2.3%. For sales excluding vehicles, after a slightly disappointing start to the quarter, a recovery is expected to +0.5% m-o-m (vs +0.1% over the last three months). The disruption to industrial output caused by the GM shock (negative in October and positive in November) has run its course. The underlying trend since end-2018 is flat or slightly negative. The full effects of the Boeing shock lie ahead.

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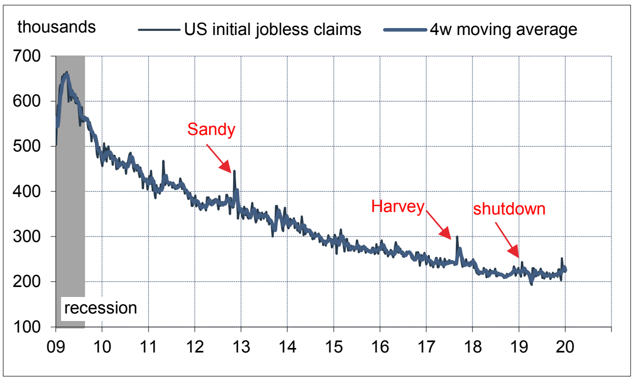
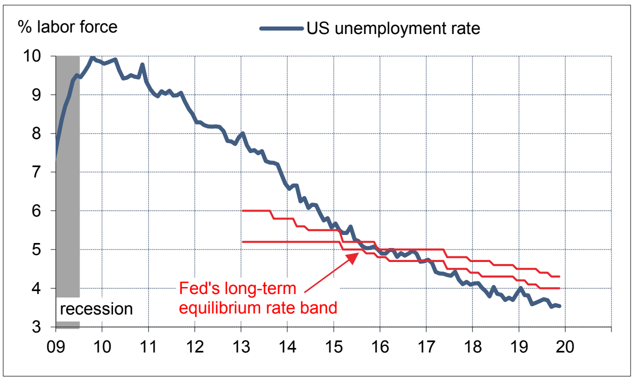
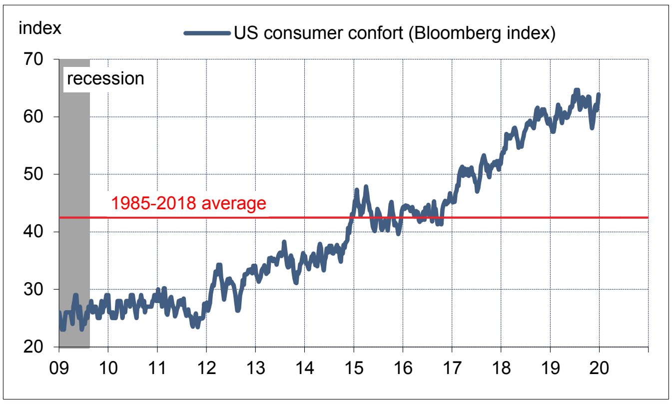
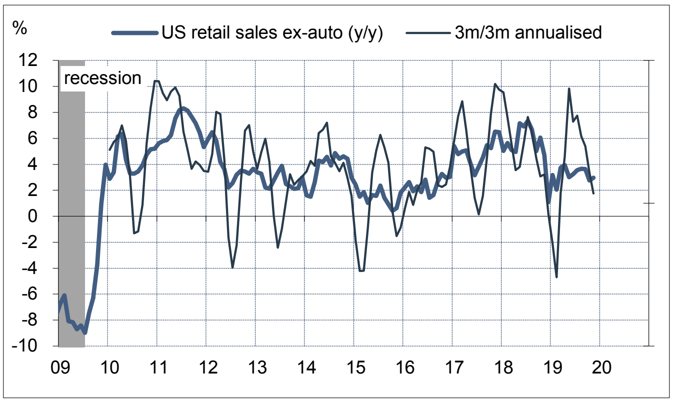
Appendix 1 - Labour market

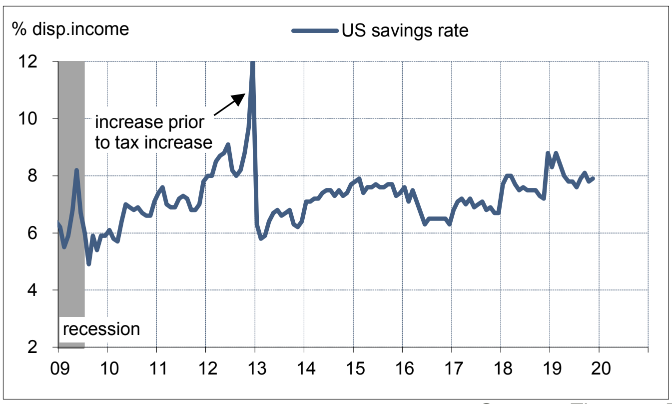


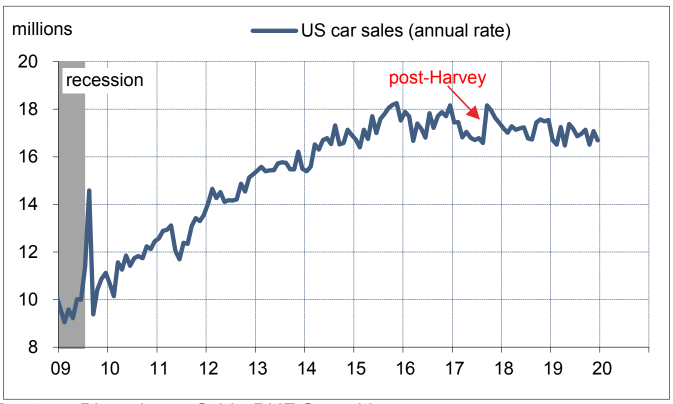


Appendix 2 - Consumer









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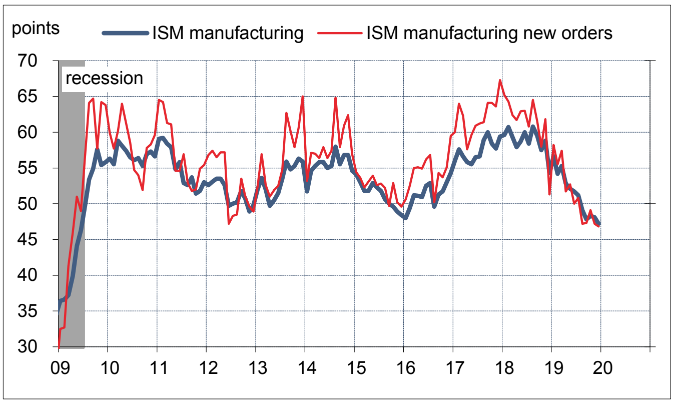
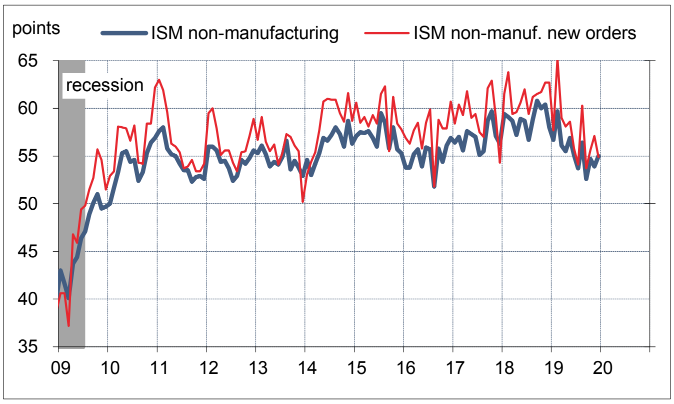
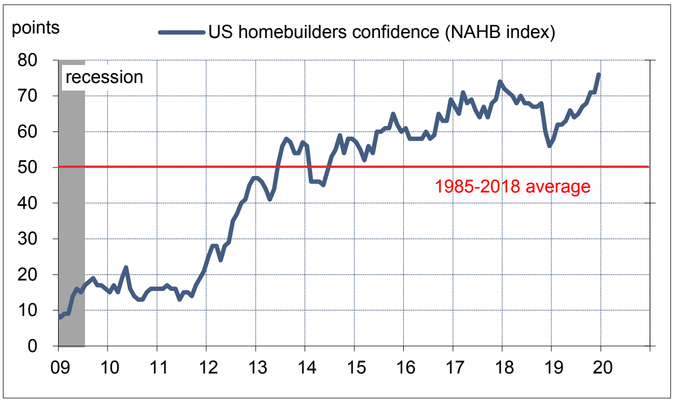
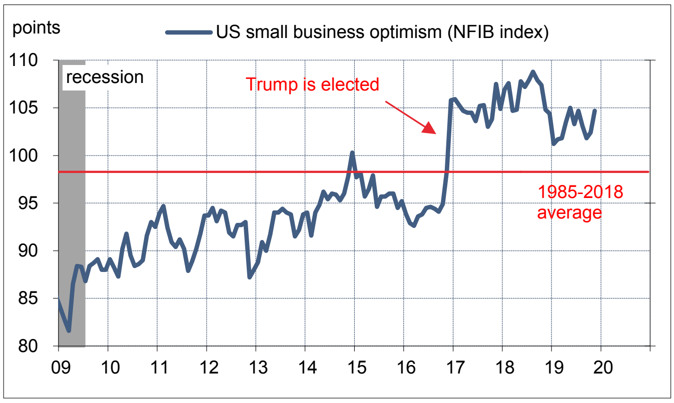
Appendix 3 - Business climate

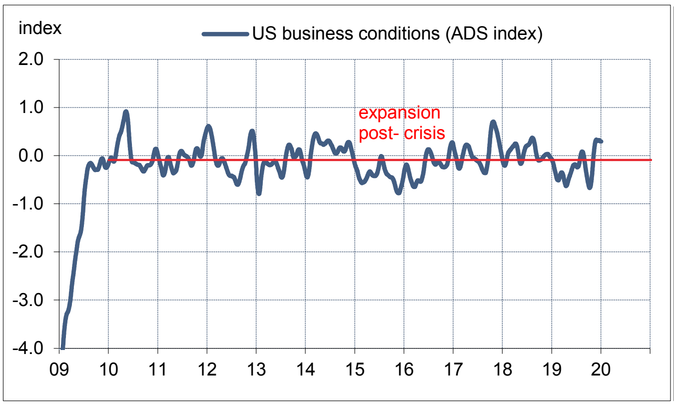


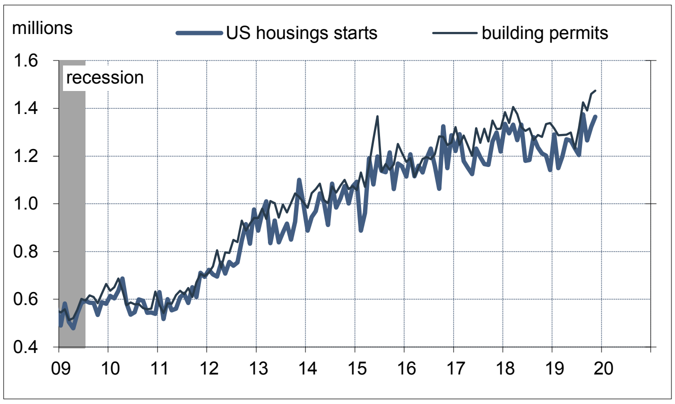






Appendix 4 - Conditions of economic activity





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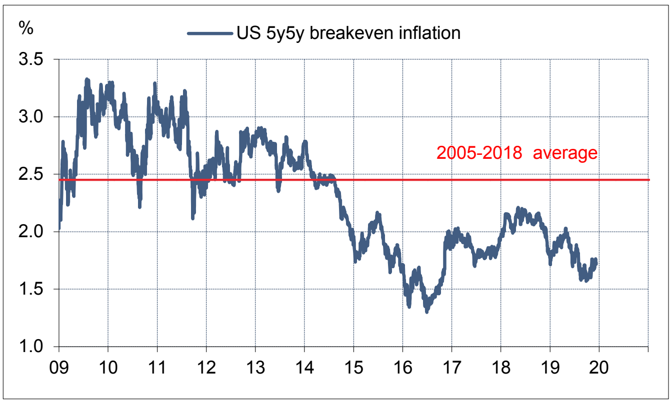
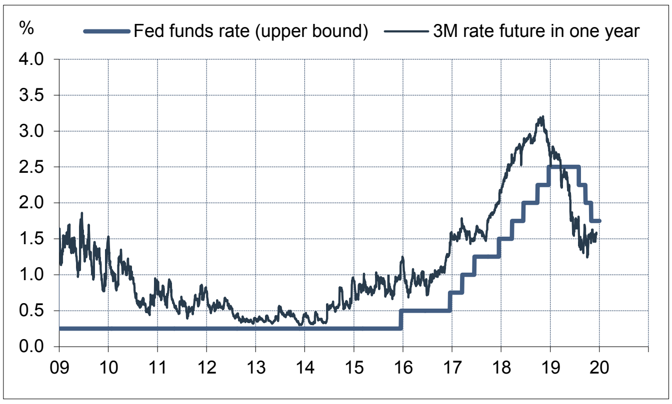
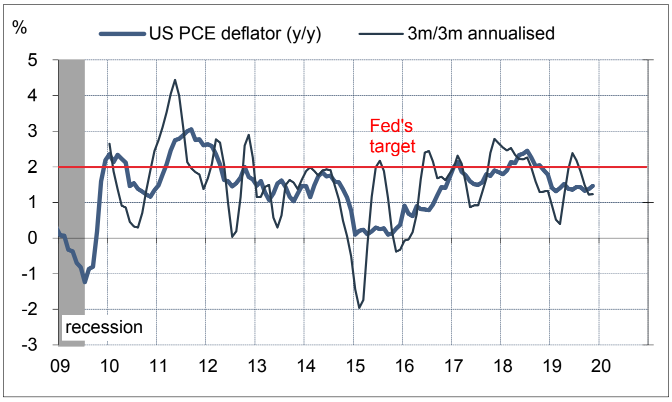
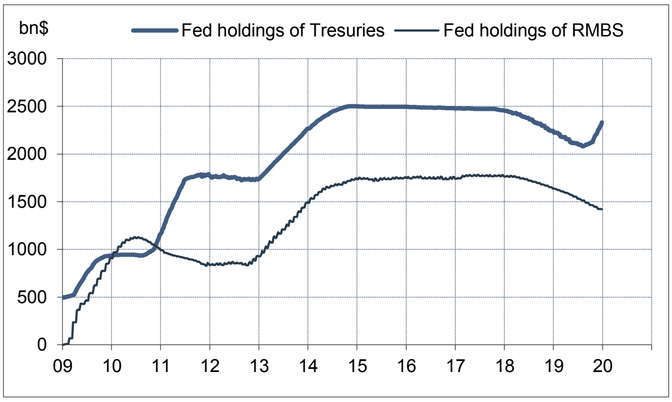
Appendix 5 - Inflation and monetary policy

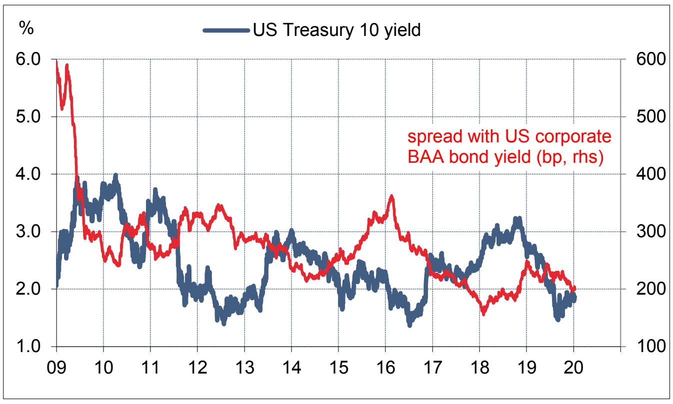


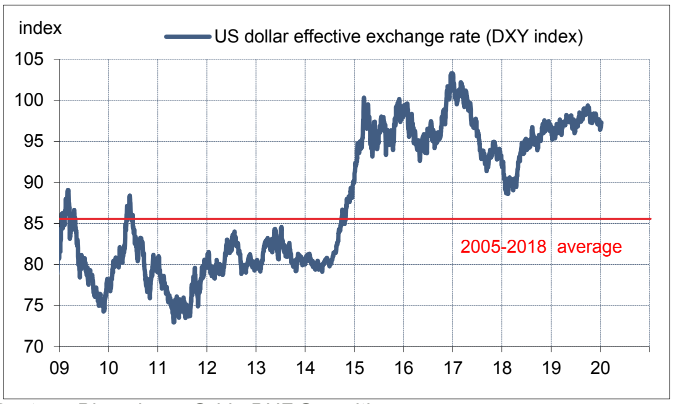






Appendix 6 - Financial markets





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