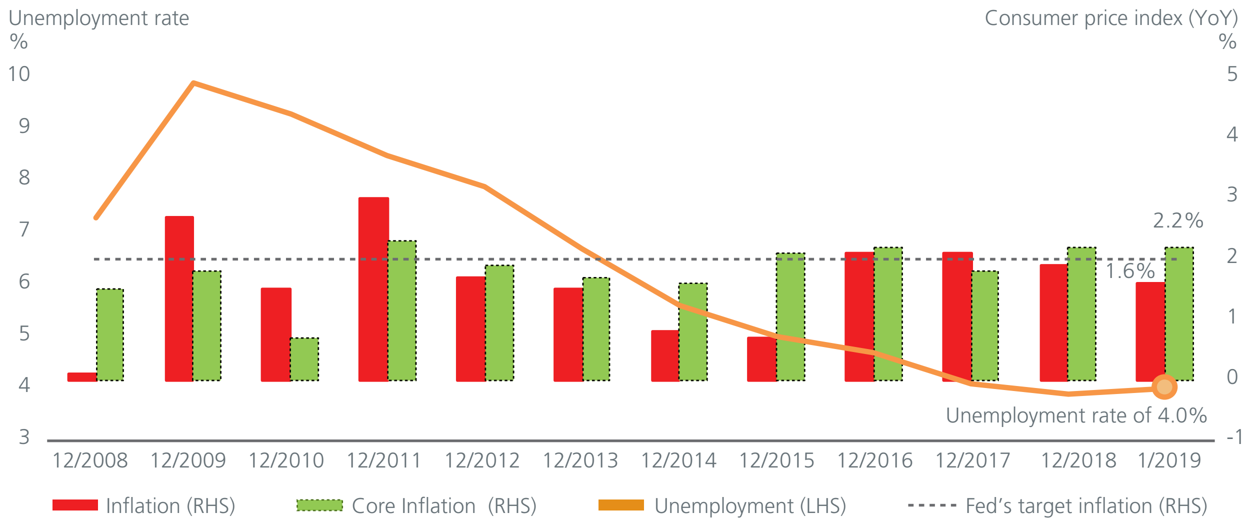
# THE CURIOUS CASE OF THE MISSING US INFLATION

**Investors and policymakers are puzzled. Inflationary pressures are tentatively hovering around the Federal Reserve's (Fed) 2% target, following a prolonged period of economic expansion, despite the unemployment rate reaching a record low (see Fig.1). Such low unemployment levels have typically pushed wages higher thus driving inflation also higher.**

**Low Guan Yi**
Chief Investment Officer of Fixed Income
Eastspring Investments

But this does not seem to be the case today. Instead, the US real average hourly earnings growth rate is an anaemic 1.7%, which lags the economic growth rate of 3.4%[2].

**Fig.1: Inflation remains soft despite record low unemployment[1]**



So, what is the reason for this missing wage pressure?

Technological progress is one much-discussed potential factor; another is the rise of low-wage employment.

## PRODUCTIVITY RISES AMID TECHNOLOGICAL IMPROVEMENT

Some suggest that the rapid rise of online retailers, such as Amazon, has exerted a key disinflationary pressure.

Upon closer inspection, however, the impact appears negligible. The 'Amazon effect' only narrows the price gap between online and offline retailers[3]; research has shown such online competition contributed 0.02 percentage point to US inflation[4].

We can safely exclude the 'Amazon effect' from our puzzle, it seems.

That said, it is important not to be overzealous and discard the impact of technology wholesale.

Artificial intelligence, for example, and the Internet of Things[5] are at the core of the technological revolution. Moreover, automation and robotics have superseded many low-skilled, routine, and administrative jobs.

Technology, therefore, provides more of a direct boost to human productivity and cost savings.

Just look at how ride-hailing apps help match drivers and passengers within minutes, eliminating the jobs of call-centre operators. More professionals can nowadays work from home using internet connections, saving on both commuting time and office expenses.

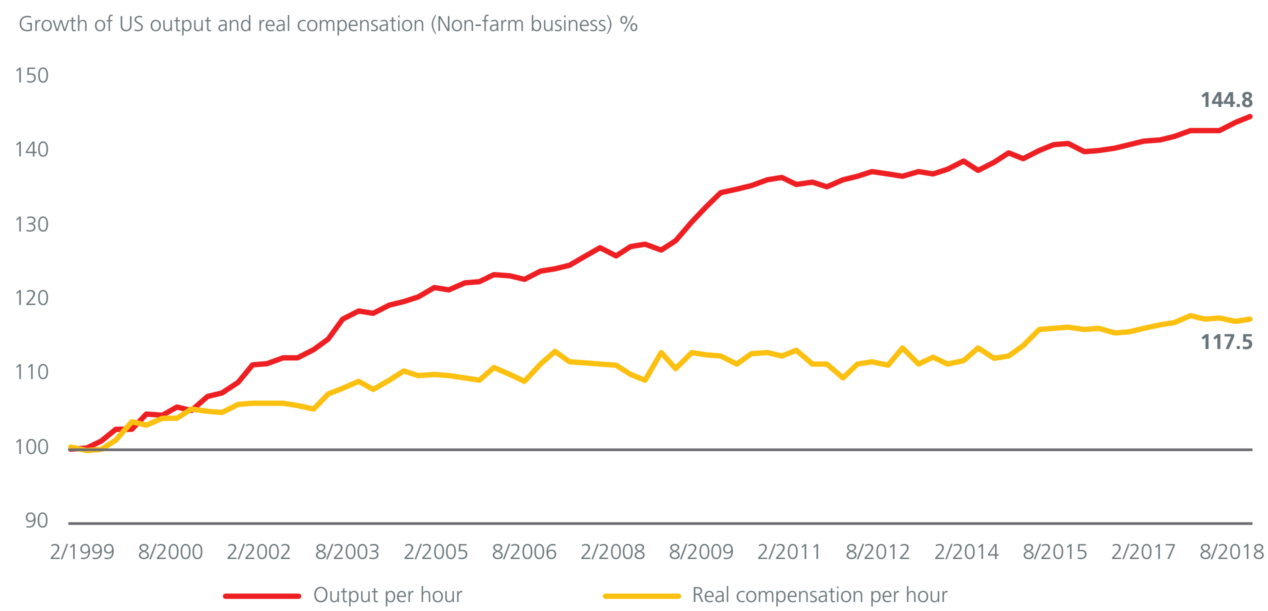
The problem seems to be that the resulting boost to productivity has not 'trickled down' to wage earners.

US output per hour, for example, has increased by 44.8% over the past 20 years, far outpacing the 17.5% growth in real compensation i.e. wages, mostly. See Fig.2.

Why has this happened?

One explanation is the waning power of trade unions. In 2018, just 10.5% of wage and salary workers in the US belonged to a union; almost half the rate in 1983. As the collective bargaining

**Fig.2: US output grows faster than compensation[6]**



power declines, it is now harder for labour to push through wage claims than in the past.

But it is not the only explanation.

## THE RISE OF LOW-WAGE EMPLOYMENT

As real wage growth has been flat-to-sluggish, it has also been difficult for seniors to not only save for retirement but also live once retired, forcing many to re-enter the workforce.

The majority of these seniors work in part-time, low-skilled jobs, mostly as personal-care and home-health assistants. There were about 2.9 million such jobs in 2016, but this number is projected to increase by around 41% by 2026, making this job category one of the fastest-growing fields in the US[7].

Unfortunately, these jobs had a median earning of just US$23,100 per year, 38.7% less than the national median of US$37,690 in 2017[7].

Such labour demographics and dynamics, as a result, have hindered wage growth despite those deceptively low (and attractive) unemployment numbers.

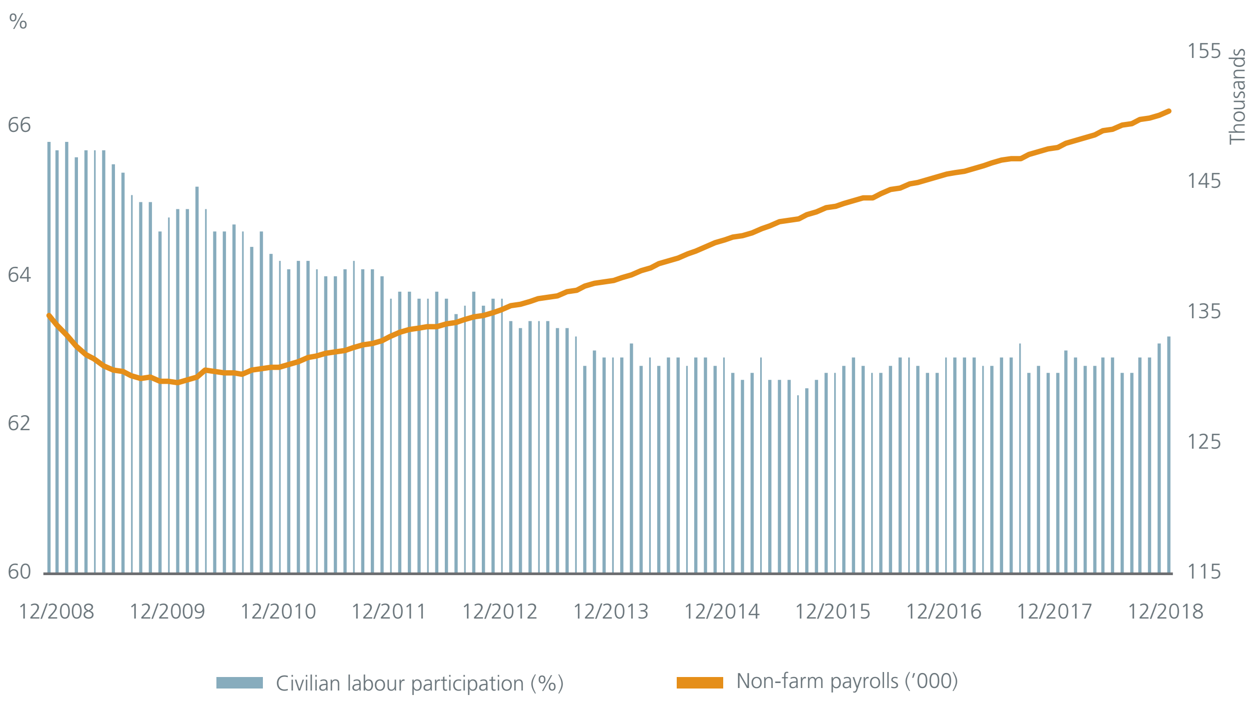
Even Janet Yellen (former Fed Chair) has reportedly admitted[8] that the record-low unemployment numbers are possibly ‘misleading’ given that the official unemployment definition excludes those ‘discouraged workers’ who have given up the search for work.

The overall result of these different forces can be seen in the widening difference between the jobs on offer and the number of individuals working.

The daunting truth (Fig.3) is that despite rising non-farm payrolls, the labour participation rate has fallen to, and hovered around 62.5% since 2013.

In other words, many Americans are being forced to have more than one job to make ends

**Fig.3: More individuals need more than one job to make a living in the US[9]**



meet, suggesting the upward pressure on wage growth remains minuscule.

As such, inflation expectations should remain low.

## TAILWINDS FOR INCOME ASSETS

This apparent lack of inflationary pressures, coupled with the weakening momentum in the US economy as well as the rising risks to the global outlook, led the Fed to signal a pause in its rate hike intentions in early 2019.

Some observers (as in mid-February), are even expecting no rate hikes in 2019 (see Fig.4).

Against this backdrop, income yielding assets should come back into favour.

The 6.9% interest yield on US high yield bonds[11], for example, looks appealing. Refinancing risks are also expected to edge lower alongside with the moderate interest rate outlook.

The impact of ageing demographics and technology is also evident in Asia, helping suppress inflationary pressures.

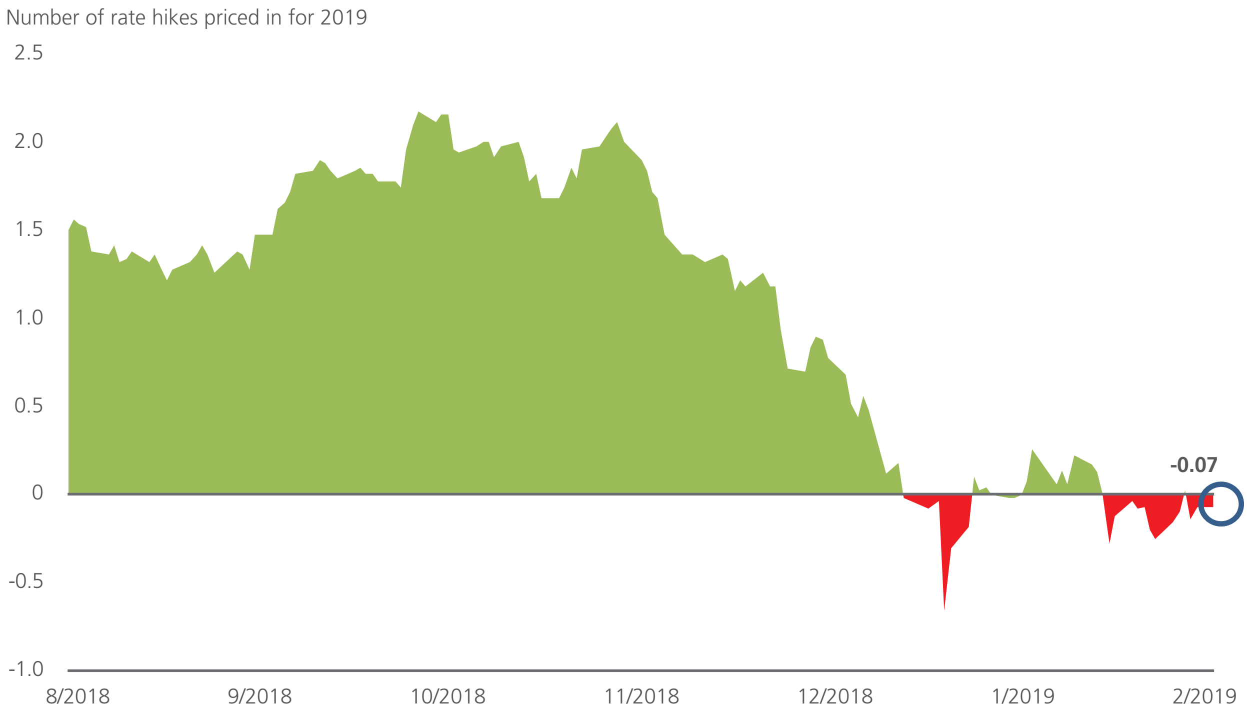
Coupled with the Fed's dovish stance, this opens the door for Asian central banks to likewise halt, or even cut, rates.

Asian high yields, currently yielding close to 9.0% and trading with spreads of more than 300 basis points[12], are thus a viable choice for income-seeking investors who have more aggressive risk tolerance (www.eastspring.com/insights/the-hunt-for-yield-begins-again).

And as Asian central banks slow rate hikes, the funding costs for Asian real estate investment trusts (REITs) are less of a burden. This should, in turn, be positive for their future dividend distributions (www.eastspring.com/insights/asian-reits-demystifying-equity-fundraising-strategies).

Investors should fear the inflation bogeyman no longer. It is time to set foot on the steady path of income accumulating strategies.

**Fig.4: Little expectation for rate cuts for 2019[10]**



Source: [1]Bureau of Labour Statistics (BLS) and US Inflation Calculator. Data as at 31 January 2019. [2]Bureau of Labour Statistics, real average hourly earnings, seasonally adjusted, from January 2018 to January 2019. www.bls.gov/news.release/archives/realer_02132019.htm; and Bureau of Economic Analysis, gross domestic product, annual increase, in Q3 2018. www.bea.gov/news/2018/gross-domestic-product-3rd- quarter-2018-third-estimate-corporate-profits-3rd-quarter-2018. [3]Alberto Cavallo, More amazon Effects: Online Competition and Pricing Behaviors, August 2018 [4]Goldman Sachs US Economics Analyst: The Amazon Effect in Perspective, 30 September 2017. [5]The Internet of things (IoT) is the network of devices such as vehicles, and home appliances that contain electronics, software, actuators, and connectivity which allows these things to connect, interact and exchange data. [6]Thomson Reuters Datastream, citing data from US Bureau of Labor Statistics, from December 1999 to August 2018. Labour productivity, or output per hour, is calculated by dividing an index of real output by an index of hours worked by all persons, including employees, proprietors, and unpaid family workers. Real compensation per hour (non-farm business sector). [7]Bureau of Labor Statistics, 2017 media pay. https://www.bls.gov/ooh/healthcare/home-health-aides-and-personal-care-aides.htm (visited February 18, 2019). [8]www.washingtonexaminer.com/unemployment-rate-can-be-misleading-because-of-labor-force-dropouts-yellen-says. [9]FRED Economic Data, Federal Reserve Bank of St. Louis, citing data from US Bureau of Labor Statistics, from 31 December 2008 to December 2018. [10]Bloomberg, citing data from Chicago Board of Trade. Spread of 30-Day Fed Funds Futures Jan20 over 30-day Fed Funds Future Feb19. Larger (positive) the spread, more rate hikes are expected. [11]Bloomberg, as at 11 February 2019. Bloomberg Barclays US Corporate High Yield (Yield-to-Worst).[12]For the 9% yield: Bloomberg, Eastspring Investments, BofAML, Citigroup, Markit iBoxx as at 31 January 2019. Asian high yields represented by BofA Merrill Lynch Asian Dollar High Yield Corp Index. For the spreads of 300 bps: iBoxx, Morgan Stanley Research.



eastspring investments

A member of Prudential plc (UK)