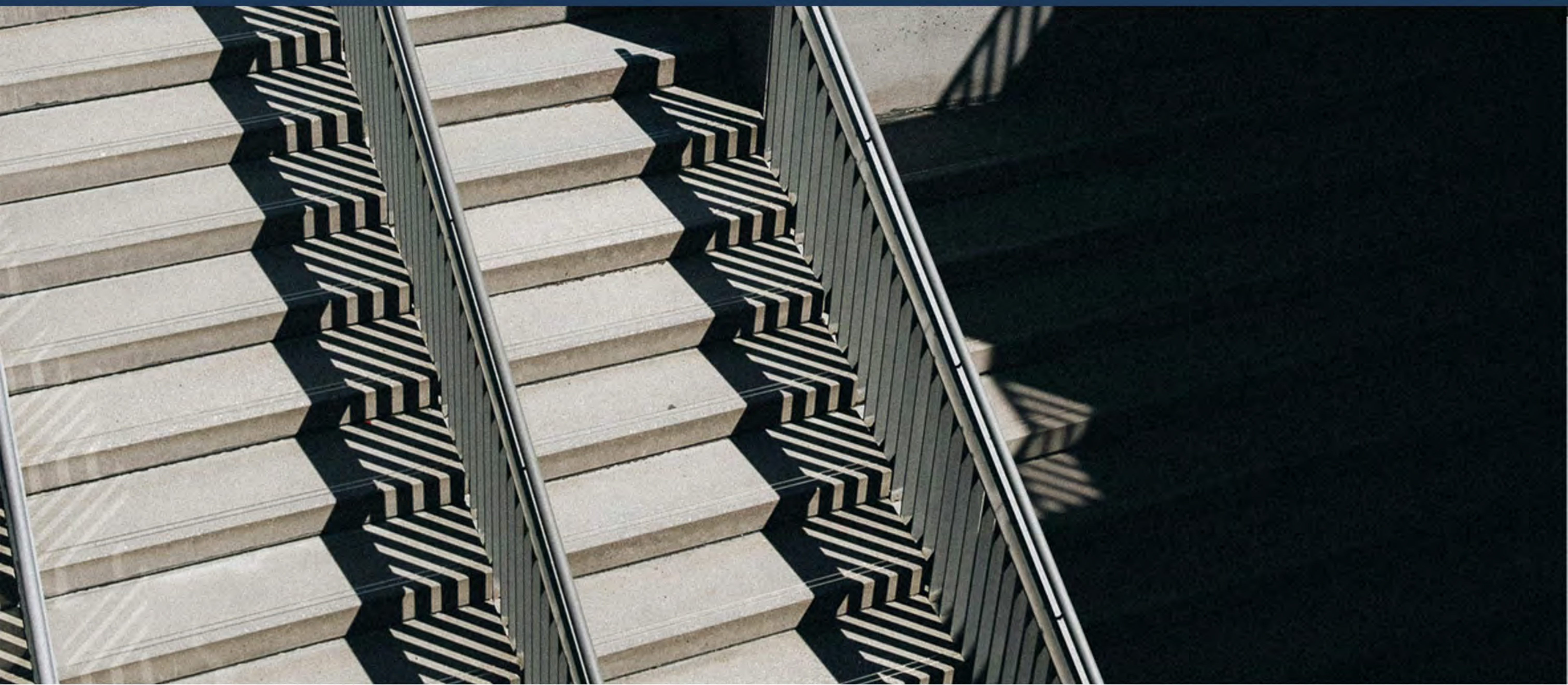

Falling inflation is the North Star guiding financial markets today. Along with strengthening global growth

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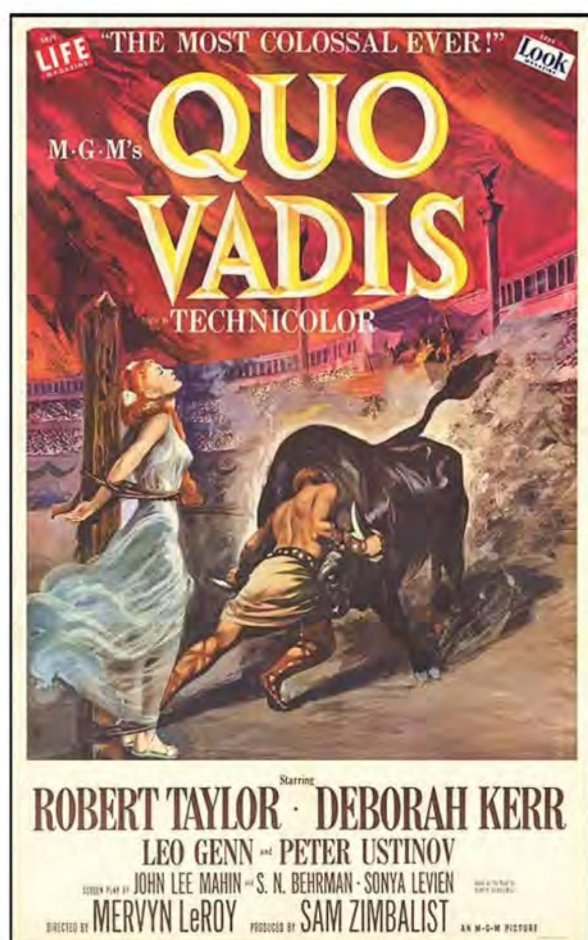
At a glance

- Slowing labour costs, more stable commodity costs and the fading effects of lockdowns point to cooling consumer prices.
- Figures for the first months of 2024 have been distorted by companies' new price adjustment policies.
- The cost-of-living temperature will remain higher than in the decade before the pandemic, when risks were skewed towards deflation.
- There are increasing signs of consolidation in the international recovery, thanks to China and the Eurozone.
- Interest rates will fall, more on the short side than on the long side.
- What are the portfolio choices and why active equity investment management is adding value again.
- Insights from the recent Ceresio Investors manager research trip to Asia.

The four forces that will restrain consumer prices

Quo vadis **inflation**? If it was able to respond, the dynamics of consumer prices would answer:



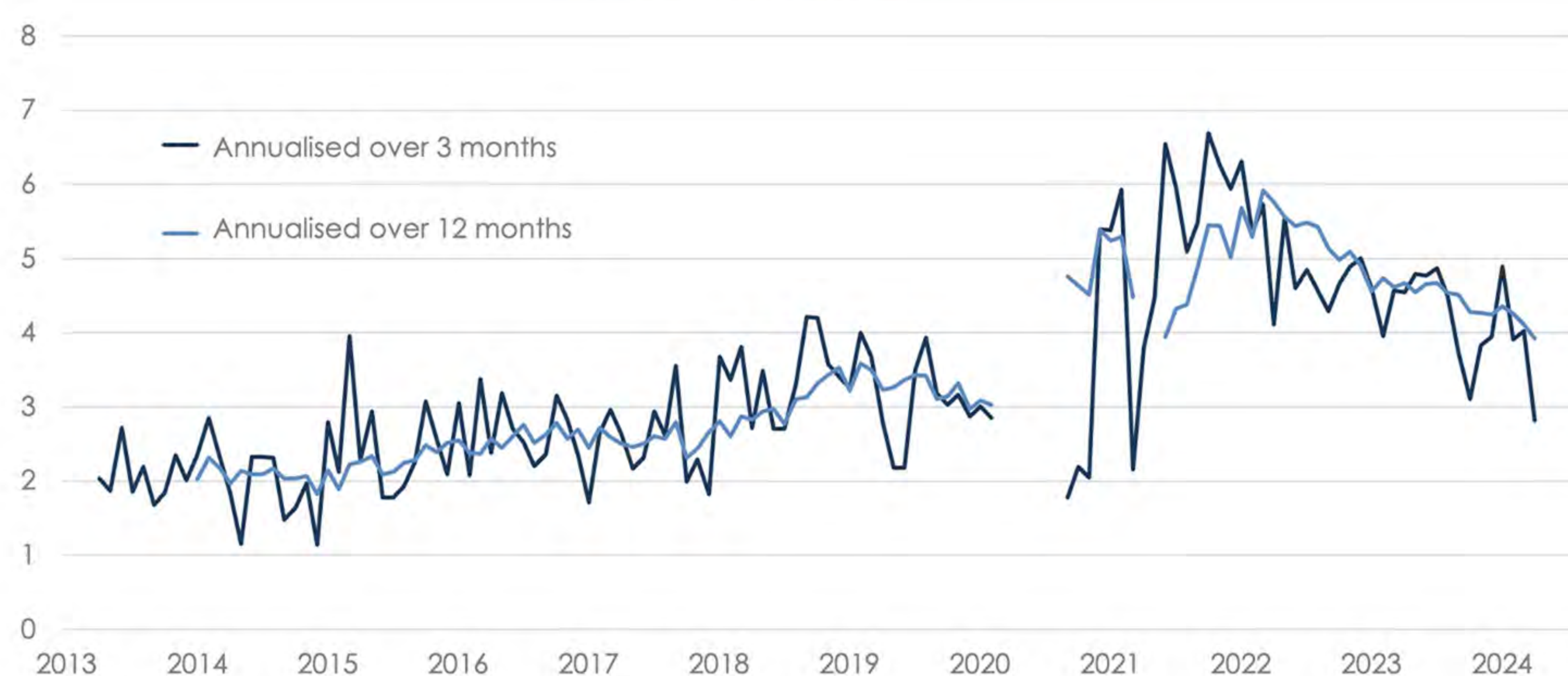
"I'm going down". In the sense that it is going down. Not an obvious answer, after the trend observed in recent months in the US and the Eurozone.

In fact, the last three **US statistical** readings have all surprised on the upside and the change between December and March, reported on an annual basis, was +4.5%, more than double the Fed's target, from +2.0% recorded in the previous three months. In the **Eurozone**, the same type of indicator, which takes seasonal factors into account, jumped from 0.5% in January to 3.5% in April. So, is the inflation response mendacious? Or is it grounded in other empirical evidence? The second, and here is why, starting with the US.

The first is that the **wage race is slowing down**: on an annualised basis it fell below 4% in April for the first time since June 2021, and on a quarterly basis it fell to 2.8% annualised, the lowest since March 2021, when the influence of the pandemic was still very strong (Chart 1).

Why is wage development important for understanding where prices will go? Because it is the **primary determinant** of home-grown inflation, i.e. it does not depend on external shocks (such as changes in the cost of raw materials) and can be governed by economic policy, monetary policy first and foremost. Moreover, **the vast majority of products purchased by consumers are services**, and services are labour-intensive. Thus, the development of labour costs is essential to understand how inflation is going. Of course, the dynamics of **labour productivity also matters**: if productivity goes up a lot, labour costs can do the same without causing inflation; but productivity has a stable trend over time, because it depends on long-term factors. Whereas wages are more sensitive to short-term conditions, such as the unemployment rate, past and expected inflation.

Gr. 1 - US wage growth slows down
(Hourly wage, var. %)



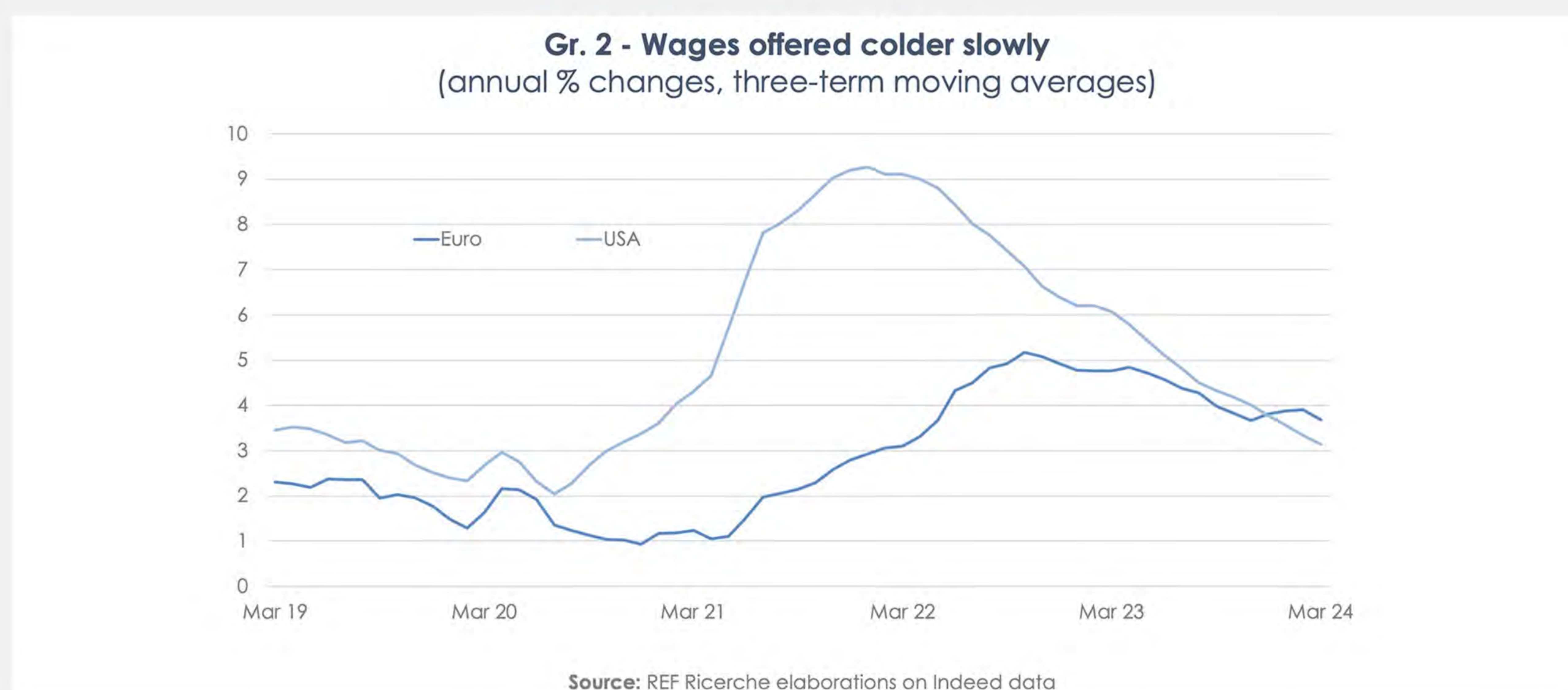
Changes accentuated by the pandemic impact have been removed
Source: REF Ricerche processing of US BLS data

In the **Eurozone**, a cooling can also be observed, at least when looking at the **wages offered** by job seekers (Chart 2). There is, however, an important difference: in the US there is little unionised bargaining and wages react faster to changing economic conditions; here it is the opposite and centralised national contracts react with delay, which means that the next round of negotiations will have to somehow incorporate a recovery of purchasing power.

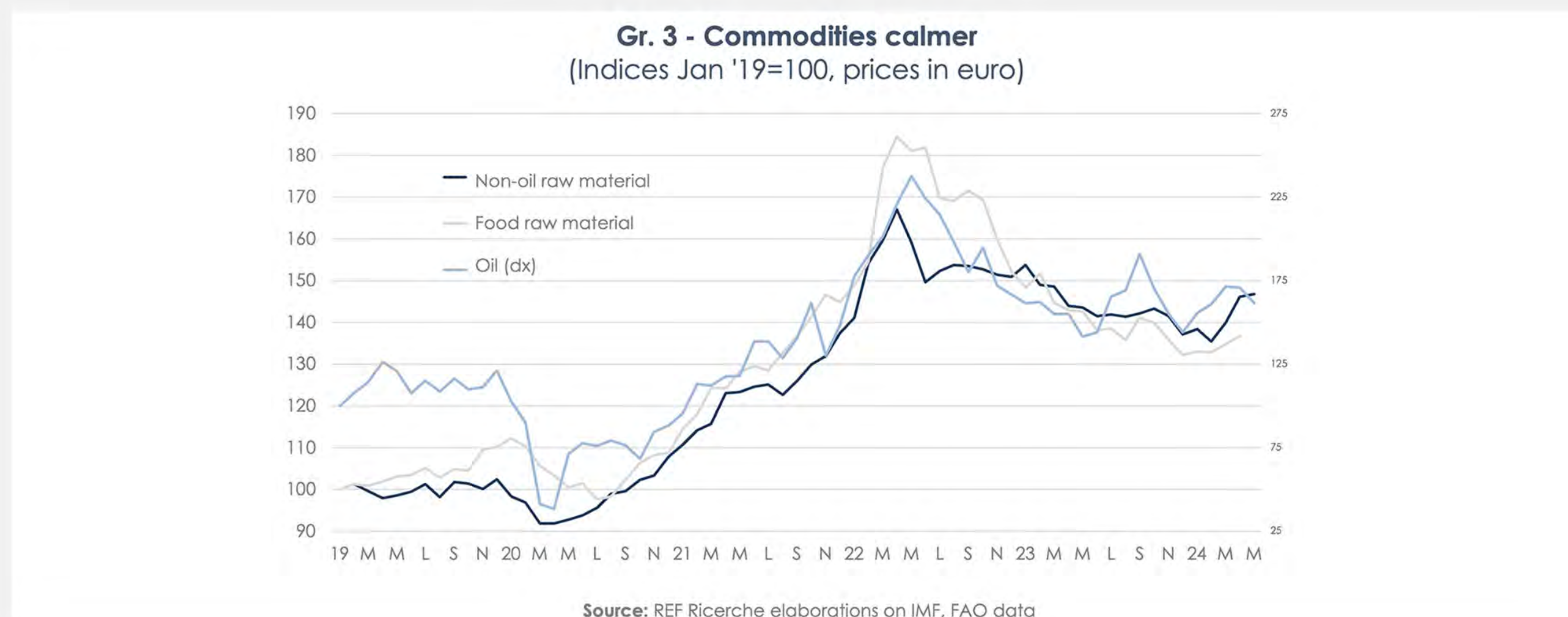
However, recent wage trends, in both the US and to some extent Europe, **promise** lower price increases in the coming months.

The second reason to believe in the decline of inflation is **statistical**. After a long period of low inflation, such as the one before the pandemic, the techniques of purification of **seasonal factors** (for example: ice-cream prices are adjusted, if at all, at the beginning of the warm season and panettone prices around Christmas time) have incorporated few, infrequent and irregular price adjustments. With inflation a bit higher, companies have to change their price lists but try to do so once a year, because it is always a delicate phase to manage with customers; usually this happens in the **first months of the new year**. This is also a form of seasonality, which current statistical filters do not grasp, however, because they are calibrated on the long series of data from the past, and are not able to 'spread' those rises concentrated between January and March over the whole year. Thus in the first quarter of the year inflation seems to accelerate.

The third reason is called **hysteresis**: the shock of disruptions in **value chains**, experienced between 2020 and 2022, is transmitted with varying delays on the different items in the cost of living. For example, the shortage of components, including microchips, has curtailed the production of **new cars**, driving up their price, which then drove up the price of **used cars** (which were more in demand because the new ones were not there), and then the cost of **maintenance and repair**, and then **rental services**, and then the cost of **insurance**... Now car prices, new and old, are no longer going up, and indeed there are discounts (especially in the absence of green incentives), and other costs are also at a standstill, while insurance costs continue to rise, because the companies still do not have a complete picture of how much damage compensation has increased.

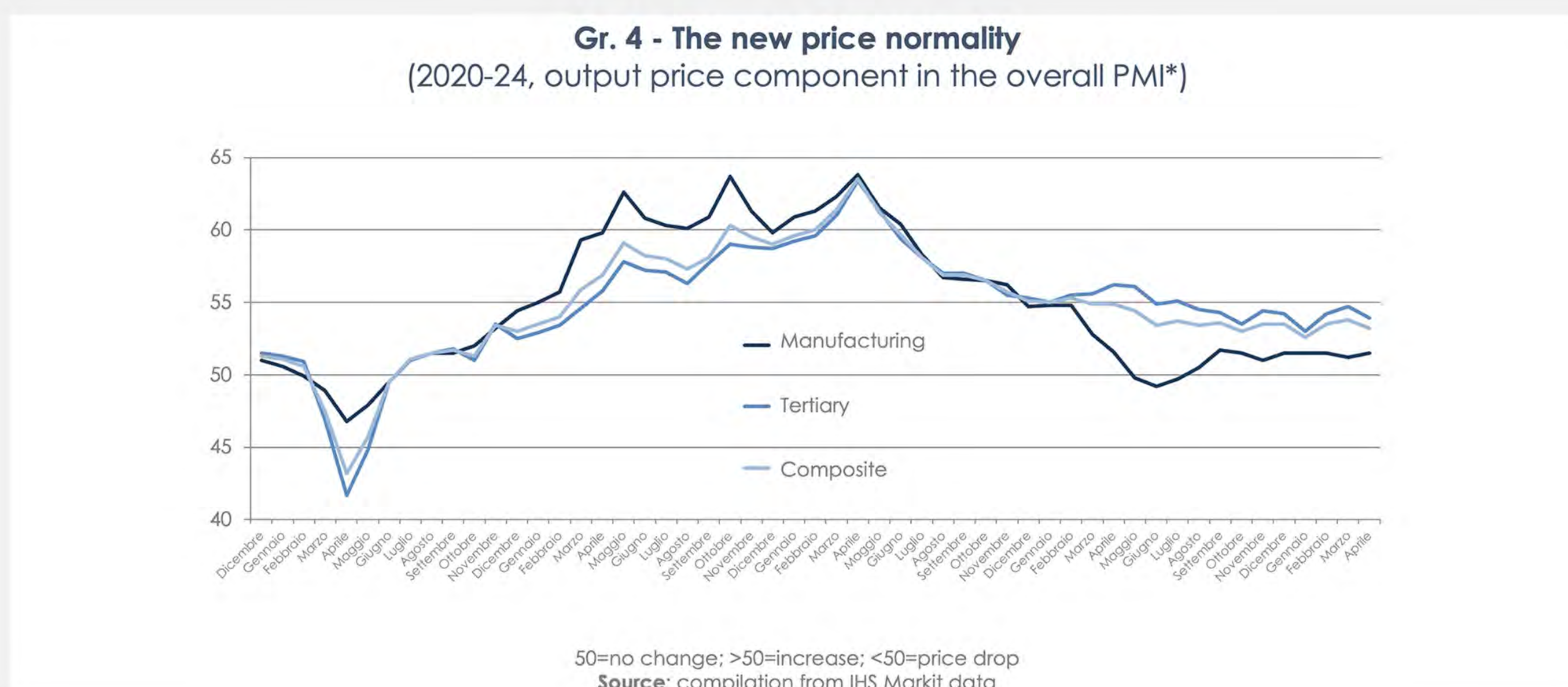


Finally, **commodity prices**, after the violent swing triggered by Russia's war on Ukraine, have stabilised at well below their peaks, although higher than in 2019 (Chart 3). Despite the recent rise of some industrial inputs, such as copper, which are sniffing the scent of global recovery.



Global growth consolidates

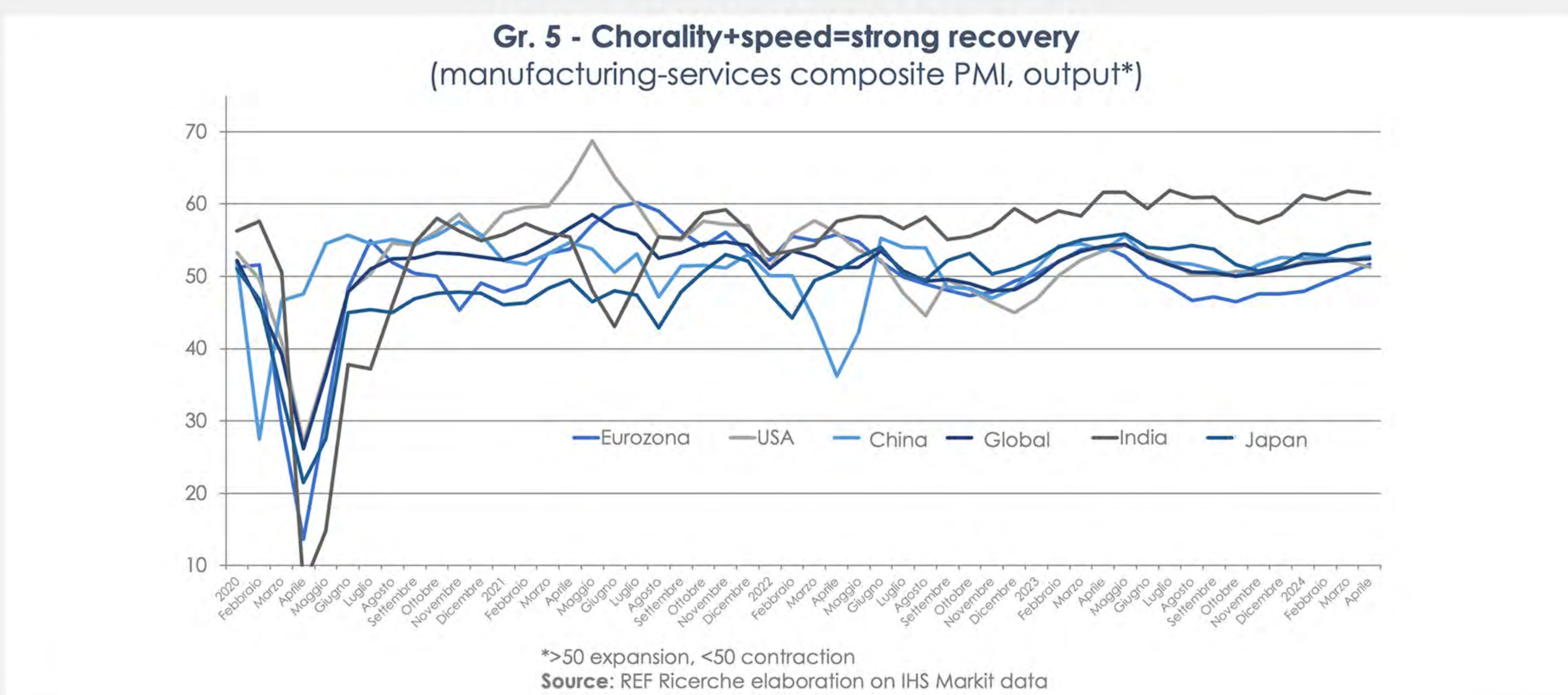
It is precisely of **recovery** that we should now speak. But first let us emphasise one last aspect of inflation: it is going down and it will go down, yes, but the picture that prevailed, in numbers and in perception, before the pandemic has gone by the wayside. We will have **'normal' inflation**, i.e. in line with what was happening before the Great Financial Crisis. With factors that will push it up (rarefaction of workers, also due to demographic dynamics; green transition; deglobalisation) and others that will contain it (competition accentuated by online trade; digitalisation of production; artificial intelligence). Thus, the price component of the Purchasing Managers' Survey (PMI) will not fall to the levels of four and a half years ago (Chart 4).



On the recovery front, **signs of global acceleration** are multiplying. From two points of view: **chorality** and speed. In the chorus, it must be noted, with some relief, that the voice of the Eurozone, until now the great absentee, has joined in. In terms of speed, the progress in the composite output index (manufacturing + private sector) was very small (52.4 in April, up from 52.3), but nonetheless allowed the index to reach its highest level since June 2023. This happened despite the **loss of US momentum**, and thanks to the further change of pace of **China**, which came out of the mire it had fallen into with its Covid-zero policy (which ended at the end of 2022), and of the **Eurozone**, indeed (Chart 5).

However, in the Eurozone in particular, **two differences** stand out: geographical, with Spain and Italy doing better than France and Germany; and **sectoral**, with manufacturing still in recession and **services** leading the way. On closer inspection, the two differences boil down to just one, which is the sectoral one, given the **automotive industry**'s difficulty in moving towards electric motorisation, which entails a drastic cut in added value for the same vehicle price. In fact, the latter is dramatically affected by the cost of batteries, which, moreover, are still only produced to a small extent in Europe, and the raw materials of which they are made in the Old Continent just don't exist.

The strength of the global recovery can also be seen in **orders**, which continue to rise, although they did not accelerate in March, and in **employment**, which also continues to increase. The latter is particularly important, because it feeds household incomes and confidence and thus **consumption**, which is the most important part of economic systems. One could paraphrase an old French saying: as long as consumption goes, the whole economy goes. And let us bear in mind that, according to our calculations, there is still a large **excess of savings** in the family purse; we are talking about the forced savings that took place during the lockdown months, when incomes were held up by government aid and spending was held down by limits on outgoings from home and social aggregations.



Gr. 5 - Chorality+speed=strong recovery
(manufacturing-services composite PMI, output*)

*>50 expansion, <50 contraction
Source: REF Ricerche elaboration on IHS Markit data

Implications for portfolio choices

What implications for **financial investments** can be derived from this set of assessments of inflation and recovery? There are essentially two cornerstones around which decisions revolve: the evolution of interest rates and corporate profits.

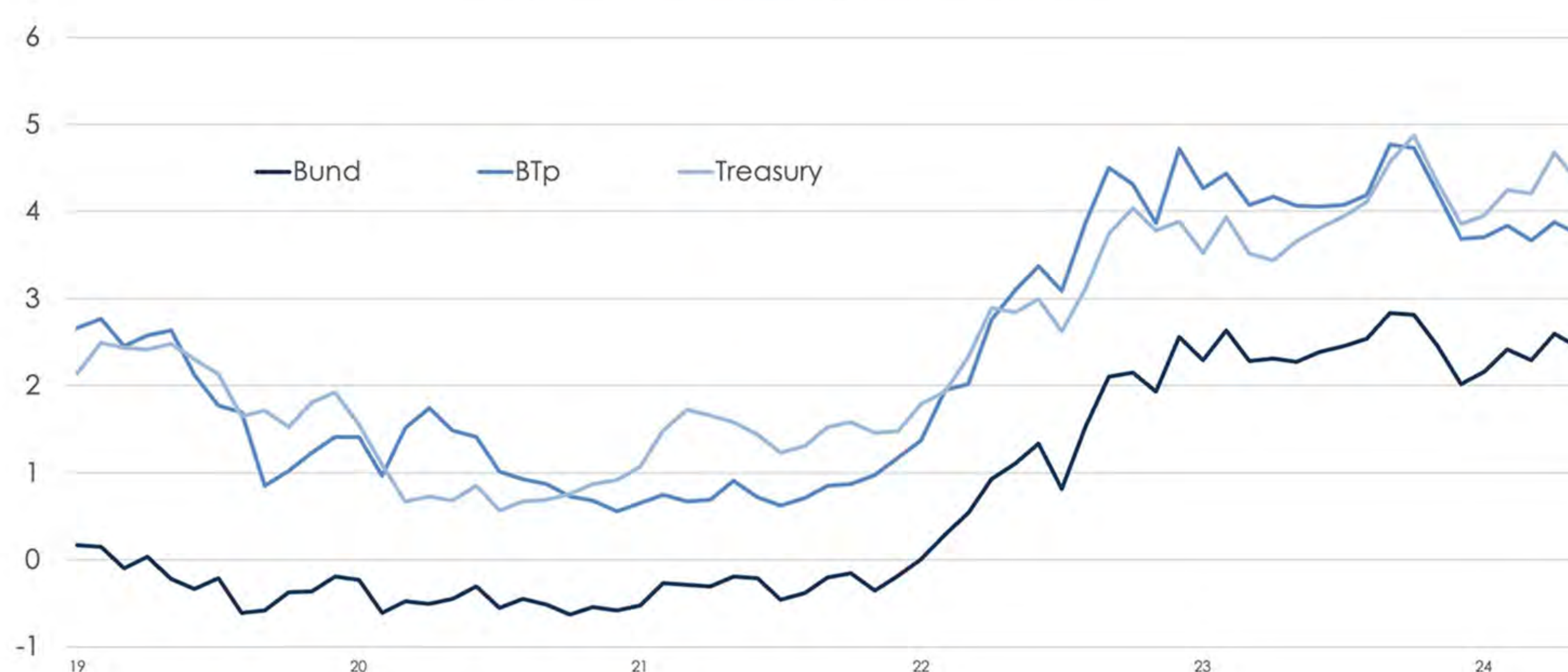
Interest rates travel along a very broad time spectrum, from the very short to the very long term. And each maturity has a different impact on the economic and financial system, hence on the assets to choose and those to avoid. The yield curve plastically represents the cost of money today and in the future, according to present expectations.

This curve normally has a **positive slope**: with short rates lower than long ones, as short securities have zero risk while those that will be repaid later are affected by the unpredictability of monetary erosion (inflation risk) and uncertainty about the liquidation price (liquidity risk) and the performance of the economy affecting monetary policy decisions (interest rate risk). Instead, since the **central banks' tightening** started, the curve has assumed a **negative slope**, incorporating expectations of future rate reductions. Expectations that have changed a lot over time, and lately in the direction of having long rates closer to short rates, i.e. the latter **higher for longer** (Chart 6). Is this latter view correct?

Based on the analysis above, no. In fact, if economic growth were to stabilise around potential and inflation to fall to 2-2.5%, **short rates** would have to fall and by a lot, and **long rates** would have to normalise around their long-term natural value, which in the US is around 1.5% real, or 3.5-4% nominal. So long rates are also on the verge of falling. When? It will all depend on the data coming out between now and June. The expectation is that inflation will resume its downward path more decisively.

And **corporate profits**? They will rise, but less than in the last two years, when they were also 'inflated' by **rising stock prices**. This possibility, in a context of 'normal' inflation, is greatly reduced. What remains, however, is the consolidation of the recovery to give certainty to the business outlook. In addition, the fall in long-term rates tends to inflate the sails of the stock markets, due to the **greater relative cheapness** of equity investments over bond investments and the greater present value of future earnings (the rate at which they are discounted decreases). Obviously, if inflation normalises to values consistent with a healthy

Gr. 6 - High long rates
(Yields % on 10-year bonds)



Source: REF Ricerche elaboration on Bloomberg data

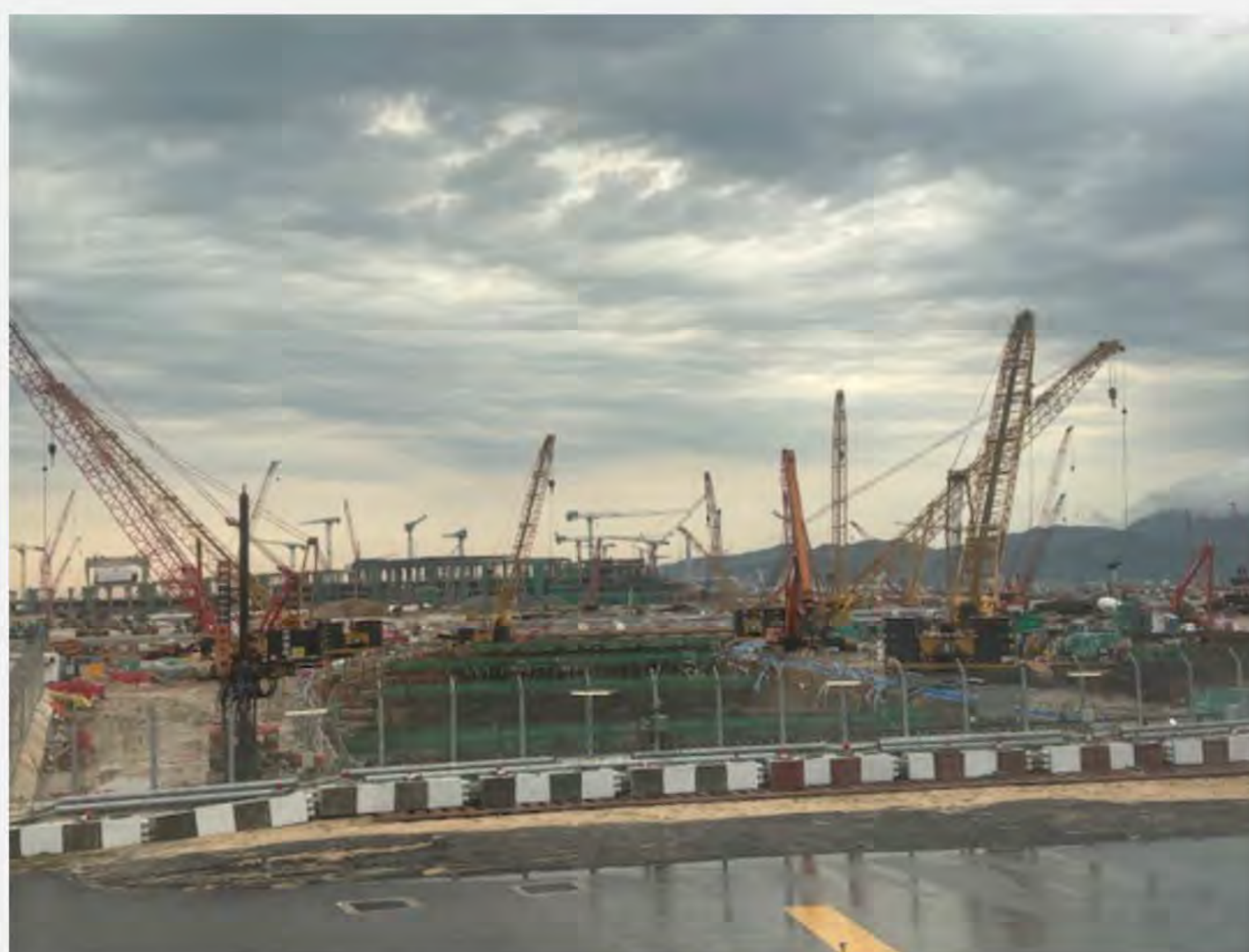
economy, and not with those of a system in danger of deflation, as in 2009-2019, then rates will also reflect this newfound health and will not return to the historically abnormal levels of the pre-pandemic period.

Beware: salutary higher rates compared to the values prevailing up to three and a half years ago **raise the bar** that companies' performance must cross to be attractive, both in receiving financing for development plans and in selecting asset managers. This means that with higher rates, **active portfolio management becomes more rewarding** than passive management. In light of the prevailing cost of money, all cats will not be cats. And this is the most important conclusion of last month's **Ceresio Investors' Forum**.

Finally, the **geographic allocation** of wealth outside the currency area to which savers belong incorporates an exchange **rate risk** and it therefore becomes relevant to understand in which direction the relationship between currencies will move. The **dollar** so far had higher rates and growth on its side. The differences will remain in favour of the greenback, but they will tend to narrow. And since what counts are the differences of the differences, the exchange rate of the world's first currency will be a little less strong. Unless.

Unless **international political tensions** enhance the lustre of its star as sheriff of the democratic world order, the US being far from conflict and having food, energy and military **self-sufficiency**. A lustre that could be tarnished by the outcome of **the presidential elections on 5 November**, should they bring to light the deep rifts that run through US society, straining the institutions created by the founding fathers and improved over time to adapt them to the changes that have occurred in various historical eras. Good luck!

We recently returned from a week of meetings with our Asia-based managers who as usual provided some interesting insights and observations about the region.



Business as Usual, Despite Cloudy Skies (Hong Kong Airport)

The picture in China remains complex and nuanced. Despite the authorities implementing measures aimed at supporting the economy, consumer demand and general sentiment remains relatively weak, driven by the on-going deflation of the property sector. On the other hand, export growth remains strong, as the country continues to successfully leverage its excess manufacturing capacity to further its global dominance across a swathe of higher value-added industries, including EV and alternative energy. Given this backdrop, our managers do not anticipate a significant stimulus-driven market rebound, but rather remain focused on idiosyncratic stock selection.

In contrast to China, the Japanese market has been one of the best performing in the world in local currency terms, also supported by a weaker Yen, although the market breadth has been quite narrow and largely driven by passive ETF flows. Corporate governance reforms are gaining further traction, inducing historically lethargic management teams to sharpen their focus on shareholder return with several noteworthy examples of companies electing to unwind legacy cross-holdings. Another important structural tailwind is a marked pick up in foreign direct investments as the country is one of the key beneficiaries of the 'friend-shoring' trend and diversification of the tech supply chain away from China, in part driven by generous subsidies from the government. Therefore, the market is now ripe for stock picking opportunities.

The Indian market remains richly valued in comparison to its neighbours around Asia, although not meaningfully so relative to its own historical ranges. There are pockets where prices have clearly run ahead of fundamentals, in particular in certain small/mid-cap companies as well as state owned enterprises. That said, the country is currently benefiting from several structural tailwinds and there remain plenty of companies that are leveraged to the strong underlying growth drivers, in particular the on-going shift from the unorganised to organised sector.

The excitement around the potential of AI has been an important thematic factor in Asia as well, given a significant portion of the underlying semiconductor supply-chain is based there. Several of our managers continue to leverage the insights gleaned from their local research teams to identify beneficiaries of the increasing capital expenditure in this area, both within Asia and globally.

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