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MACRO MORNING BRIEFING

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'Stag' More Worrying Than '-flation'

G10 economies' weak growth a bigger problem than inflation

- OECD forecasts do not point to strong stagflation risk globally
- Government bond performance indicates term premia in UK and US
- More central bank rate cuts this week, but Fed limiting policy space

US productivity advantages clear among developed economies

One of the more memorable moments of Federal Reserve Chairman Powell's post-meeting press conference on May 1 was his response to a question regarding the prospect of stagflation in the US. Q1 data reported the prior week certainly provided for uncomfortable reading in that regard, with annual quarterly GDP falling to 1.6% and the core price index accelerating to 3.7%. Powell answered by saying he saw neither the 'stag' nor the '-flation'.

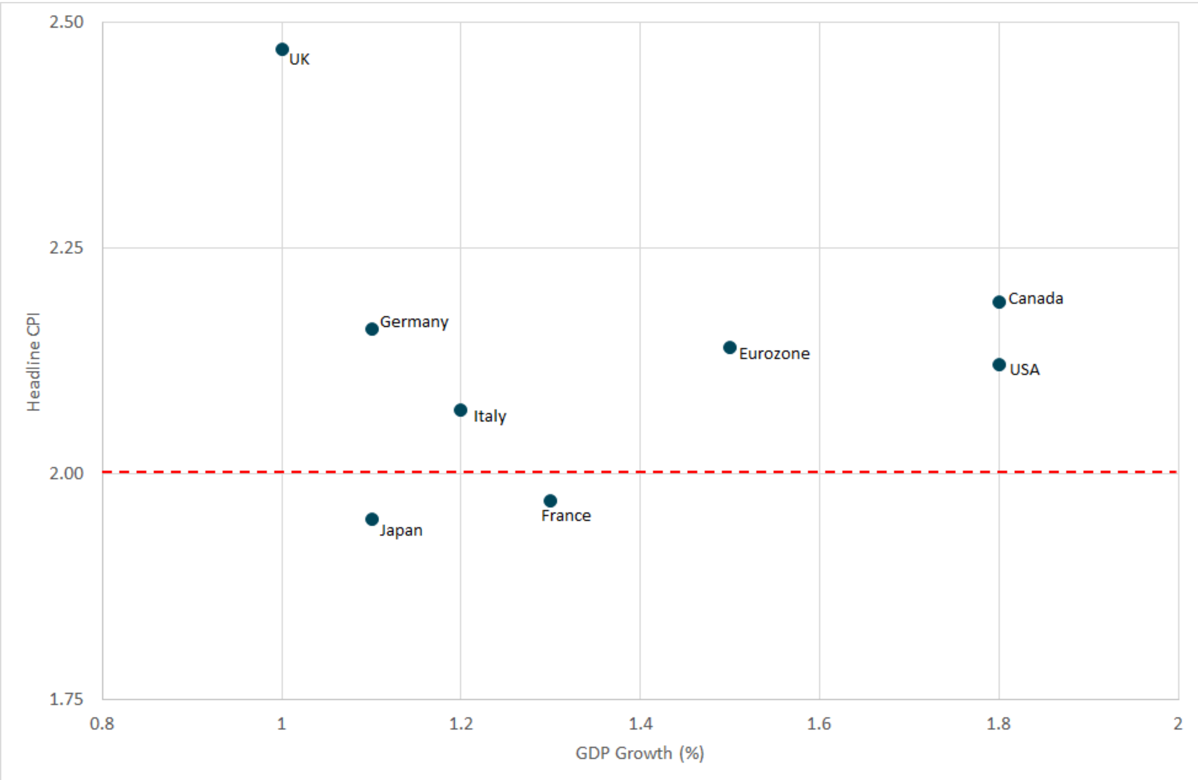
We would broadly acknowledge that it is perhaps too early to judge the US or even global economies moving into such a stage. In the context of the Fed's employment mandate, US real wage growth has been positive for 11 consecutive months, after two straight years of declining real wages between 2021 and 2023 due to high headline inflation. Further improvements remain possible given the US's advantages in productivity growth. Declining real wage growth is one of the most potent effects of stagflation. The US is not there yet.

Most global economies have managed to move away from the extreme stagflation risk of the past two years and their central banks continue to seek an opening to cut interest rates. There is no guarantee of success, however. For example, the Reserve Bank of Australia, which meets this week, could provide an opposite example. Throughout its previous policy statements, the RBA's policy board acknowledged that wage growth was high, but also that the "level of wages growth remains consistent with the inflation target only on the assumption that productivity growth increases to around its long-run average". Yet in the wake of Australia's strong Q1 CPI print, the market has priced out a full cut for this year and, on balance, is considering the prospect of a hike again. This implies that the market is highly sceptical of Australia's ability to deliver such productivity growth.

We see a similar situation across developed markets, which goes some way to explain delays in easing. European Central Bank President Lagarde remarked almost a year ago that for the Eurozone, "the effect on inflation from rising wages has recently been amplified by lower productivity growth than we had previously projected" and "employment growth…in services…has only seen meagre productivity growth". With nominal and real rates now high enough to restrain demand and supply issues having eased, the 'inflation' part of stagflation should be more manageable due to weaker demand. But stagnation remains a clear risk.

The OECD last week published its latest forecasts. Within the G7 economies (exhibit #1), only the UK appears to be facing clear stagflation risk, as inflation is expected to remain above the Bank of England's target in 2025 while growth remains subdued. The other key economies seem capable of getting inflation back to around 2% y/y – but none of them is expected to surpass 2% real GDP growth. The 'healthiest' mix, whereby growth is relatively strong but without high inflation, remains in North America, with the US leading the way.

Exhibit #1: OECD 2025 Inflation vs. Growth Outlook

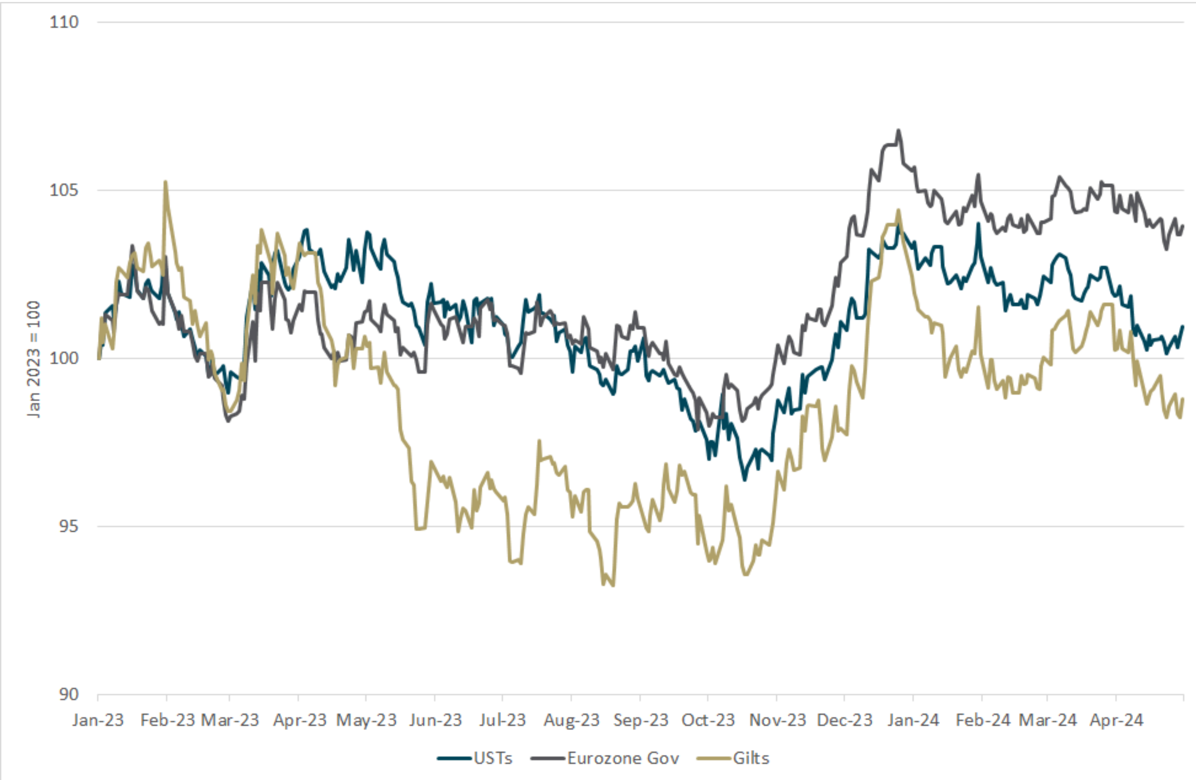


Source: OECD, BNY Mellon

Stagflation would have implications for asset allocation as well, especially in bond markets. High inflation may be seen as conducive to reducing nominal debt burdens, but the prospect of higher-for-longer rates and steeper curves due to a rise in term premia will continue to pressure budgets. On the revenue side, the lack of real income growth (due to inflation persistence and lack of productivity growth) will also restrain spending and investment, with a knock-on effect on government finances. Combined with the lack of growth in general to service liabilities, the return profile would not be promising for the local fixed income market. Even for the US and its Treasury market, which continues to enjoy reserve status, this is a matter which requires close monitoring due to fiscal burdens.

Looking at the total return profile on US, Eurozone and UK debt, it does appear that the US and UK are currently struggling. Considering the natural advantages in both markets (Gilt market maturity profile is twice the G7 average), the Eurozone's lead surprises us. In a stagflation context, the Eurozone certainly faces greater growth challenges, while traditionally high savings rates can serve to inhibit inflation. This may change over time given that the main source of Eurozone savings – trade surpluses – may decline structurally amid structural changes in global manufacturing, but financing in the near term is less of a worry. Even taking into account intra-Eurozone divergence, the tools and facilities established during the current budgetary cycle have supported local sovereign bond markets.

Exhibit #2: Total Return Indices, Government Bonds



Source: Bloomberg, BNY Mellon

Another G10 economy which has been the subject of concerns about potential stagflation is Sweden. The Riksbank this week could become the second G10 central bank to begin rate cuts, after the Swiss National Bank. There is still a case for remaining on hold with headline inflation above 4%, but with the unemployment rate heading towards high single digits, support for the economy appears necessary. The Riksbank has been concerned about the risk of imported inflation throughout its tightening cycle, but if household cashflow is affected strongly enough – which has been the case over the past 18 months due to high levels of real estate leverage – the demand channel should soften enough to limit inflation impulse.

We can see in exhibit #3 that although the KIX import-weighted effective exchange rate index is rising again, the trend decline in imported consumer goods prices is flatlining. Furthermore, given that the exchange rate is considered relatively undervalued, the Riksbank can take comfort from the view that even an easing cycle should not lead to excessive weakness. The situation with the JPY remains an exception.

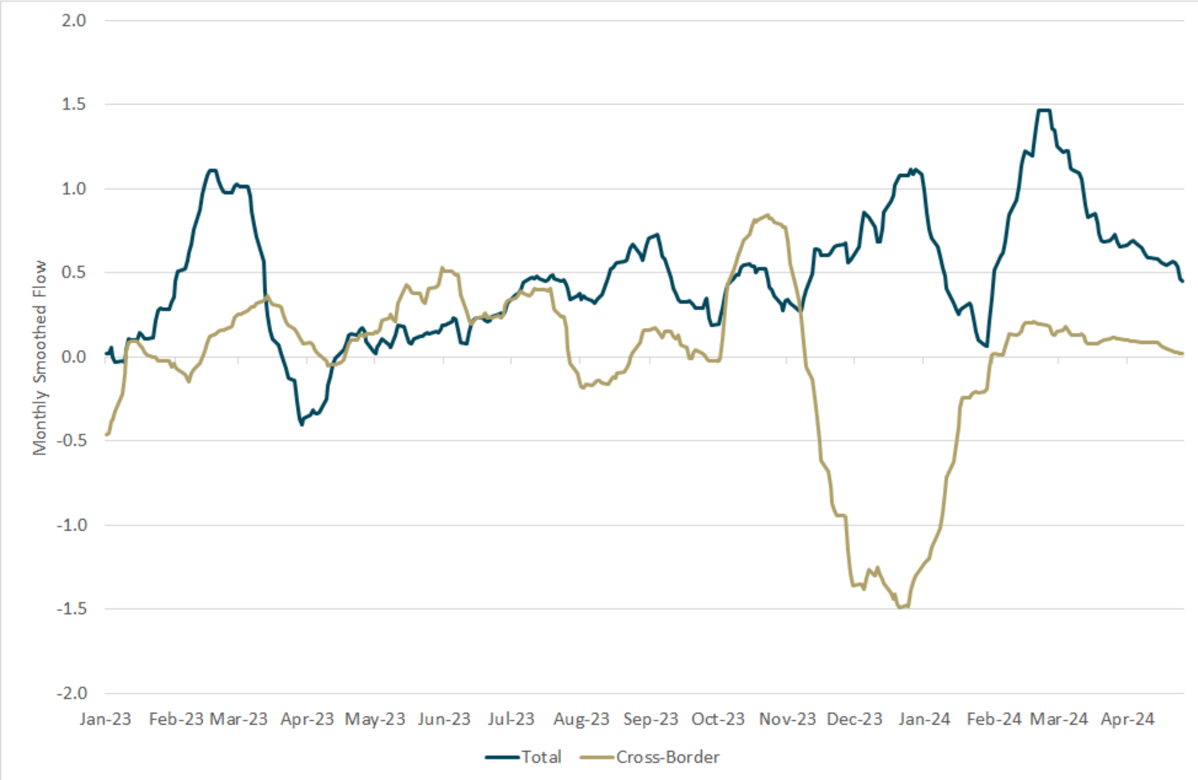
Exhibit #3: KIX vs. Consumer Goods Import Prices

Source: Macrobond, BNY Mellon

Rate decisions are due in Brazil and Mexico this week. Both central banks are expected to limit rate cuts to 25bp – if any take place. There does not appear to be any rush to start loosening financial conditions excessively, especially with the Fed outlook now seemingly uncertain. Although the combination of a less-hawkish-than-expected FOMC decision last week and a soft employment report two days later has probably precluded any prospect of hikes this year, policy space from the Fed for emerging markets is likely going to be far smaller than previously envisaged. As a result, the material asset rotation into key high real-yield bond markets, such as those in Latin America, will have to wait (exhibit #4).

We remain positive on Asia-Pacific flows as China's reflation prospects continue to improve and currency valuations in the region appear much more attractive, especially now that the market (and Japanese authorities, it appears) have put floor under yen for now. For APAC, lack of growth is certainly a bigger structural concern than inflation, but resources look set to be deployed for some near-term support for household demand.

Exhibit #4: LatAm FX and FI Flows



Source: iFlow, BNY Mellon

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Please direct questions or comments to: iFlow@BNYMellon.com

Geoff Yu

EMEA MACRO STRATEGIST

CONTACT GEOFF

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