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Monday Macro Highlight: Mr Phillips, your curves are deceiving

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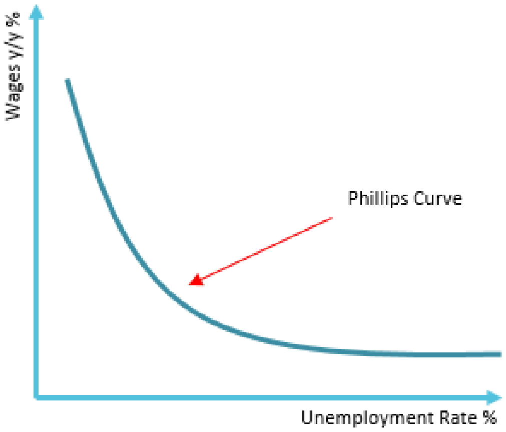
Over recent years, one long standing economic theory has been consistently belied by the data: when the economy is doing well and unemployment falls, wages should start to rise. This relationship is best characterised by the Phillips Curve, a graph named after the economist William Phillips (shown below).



	Current		Previous	
	Wages (y/y)	Unemployment Rate	Wages (y/y)	When
Japan	2.3%	2.4%	4.4%	March 1989
UK	3.3%	4.0%	4.5%	October 2004*
US	3.0%	3.9%	4.7%	December 2000
Eurozone	4.2%	8.3%	4.7%	June 2006

Source: Thomson Reuters Datastream, Capital Generation Partners

And so with unemployment at near historic lows in Japan, the US and the UK, many investors have been asking, "Where is the wage inflation?"

The table above compares current wage growth and unemployment rates to a series of moments in history with equivalent unemployment rates (and falling rates); and although we are comparing economies with the same unemployment conditions, the wage growth is quite different[1].

So why is wage inflation missing despite such low levels of unemployment? Potential causes that have been touted include macroeconomic factors, such as the weakness in productivity growth (output per worker) and declining inflation expectations; as well as recent structural changes in the labour market, such as changes in labour force participation or the increase of part-time workers in total employment and zero-hour contracts. I think one of the more interesting reasons why wages aren't rising is to do with the shape of the curve in the graph above at levels of high unemployment and low wages. Note that the curve is flat in that domain. This implies that wage inflation is irresponsive, not only to negative shocks, but also to positive shocks to labour market conditions under a low wage inflation environment. In the data chart below, you can see the most recent data points for Japan, the UK, US and the Eurozone (the orange dots show this decade - the red dot is the most recent observation) are very flat. The observations typically hover just above the zero line of the vertical axis.

Intuitively, the irresponsiveness of wage inflation to positive labour market shocks can be interpreted as firms working through recovery after a recession and waiting until they make sufficient profit to increase wages. And where companies expect future recessions, they may hesitate to increase wages, fearing that this will be difficult to reverse when hard times hit again. This is also compounded by the fact that output per worker - productivity - is already low by historical standards, which causes a situation where wage inflation is weak, in spite of an economic recovery and low levels of unemployment. This interpretation makes sense in the current climate, in which many analysts are expecting a US recession with global ramifications at some point over the next two years, and takes into account the implications that a difficult Brexit could have for the UK and the Eurozone.

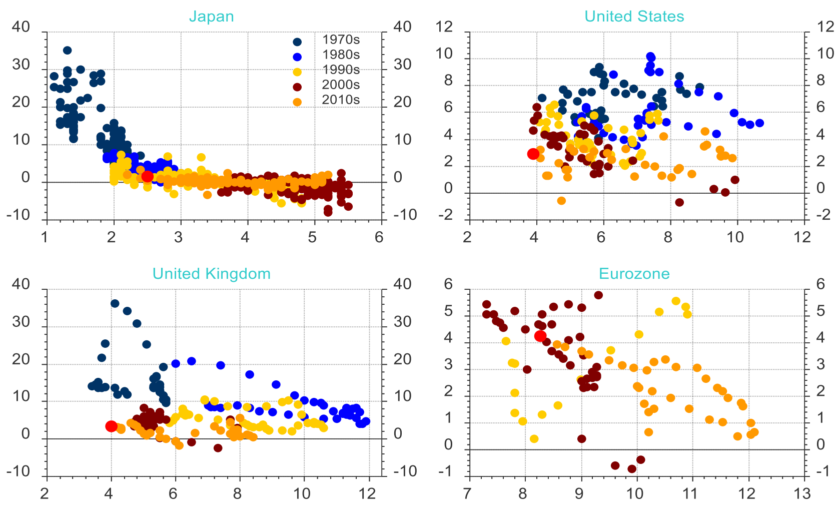
So what is next for wages? Will they rise? It appears, just based on the charts below, that the most recent observations of wages and unemployment in the UK and Japan are at an inflection point: the

[1] The UK is the exception; unemployment has never been this low in the data sample used (circa 1970 to the present).

kink between the shallow and steep parts of the curve where, if unemployment were to fall further, wages would start to rise rapidly. Indeed, in the Eurozone, wages are rising in a very linear fashion as the unemployment rate falls; so the Phillips curve relationship is holding true, but just more linear than that of the UK and Japan. For the US, the relationship does not appear to exist.

One of the reasons why inflation and inflation expectations are so low is because of the low wage growth just discussed. More than 50% of the product basket used to calculate inflation is actually made up of services, and the largest component cost to service providers is wage costs. If we are about to see a rise in wages, then we will see a sharp rise in company costs and inflation. This would have an impact on our clients' portfolios: nominal yields would rise causing bond prices to fall. Equity prices would likely also fall on the back of rising labour costs and higher interest rates that affects their cost of capital – and all this without a rise in labour productivity. It is not impossible to see inflation running away in the short-term - more than we have experienced for quite some time, so some inflation protection would be wise.

G4 Phillips Curve



Source: Thomson Reuters Datastream, Capital Generation Partners

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