dataLayer = [];

Why It's Still Too Early to Worry About Inflation

Author:
Agam Sharma
Managing Director
Portfolio Manager
Global Multi-Asset
New York

13 February 2018

While we are happy to see wage growth finally accelerating (finally), we think it may be too soon to conclude on the ending from one recent data point. While the one-month spike in wage inflation spooked the bond market, we believe wage inflation will continue on a gradual recovery path.

The last wage growth reading is likely an overshoot: Despite tightness in the U3 unemployment rate (percent of the labor force unemployed 15 weeks or longer), the U6 (including part-time workers who want to work full time) still shows slack. And both readings are not as relevant as they used to be. The financial crisis caused an abrupt drop in employment followed by a slow recovery as millennials replace retiring baby boomers in the workforce. In our view, gains from here are likely to be harder to come by since the labor participation rate is still recovering and has a long way to go.

The good news is we believe we are midway through the business cycle, when rising wage growth usually coincides with profit margin expansion. On the other hand, corporate cost-cutting is in the early stages of the cycle, which anchors a low base of fixed cost to build higher operation leverage. As demand recovers, revenues increase while fixed costs remain relatively stable. This opens up room for companies to increase wages without damaging their profit margins.

It also leaves room for companies to begin investing in productivity again. This time around, we believe we're at the beginning of a capability cycle – a term that describes periods where investments are made by companies that have plenty of capacity but are worried that, after not investing in their businesses for years, they are vulnerable to new

competitors. After nearly a decade of rewarding CEOs for financial engineering and hoarding cash, CEOs are now preparing constituencies to expect more balance, with well-crafted investment in new technology and capability aimed at keeping disruptors at bay. The goal of this capability cycle is efficiency enhancement, and it is already contributing to a lift in productivity, which is should help prolong the cycle through disinflationary growth.

As long as demand and margins are accelerating, and fears of business model disruption are spreading, we see the capability cycle expanding, leading to a disproportionate productivity response. The capability cycle is starting at a low level, yet as it accelerates, it has the potential to push out supply curves and stop the global output gap from moving into late-cycle status. That will require an impressive cycle ahead for productivity, yet we do believe that is where we are heading.

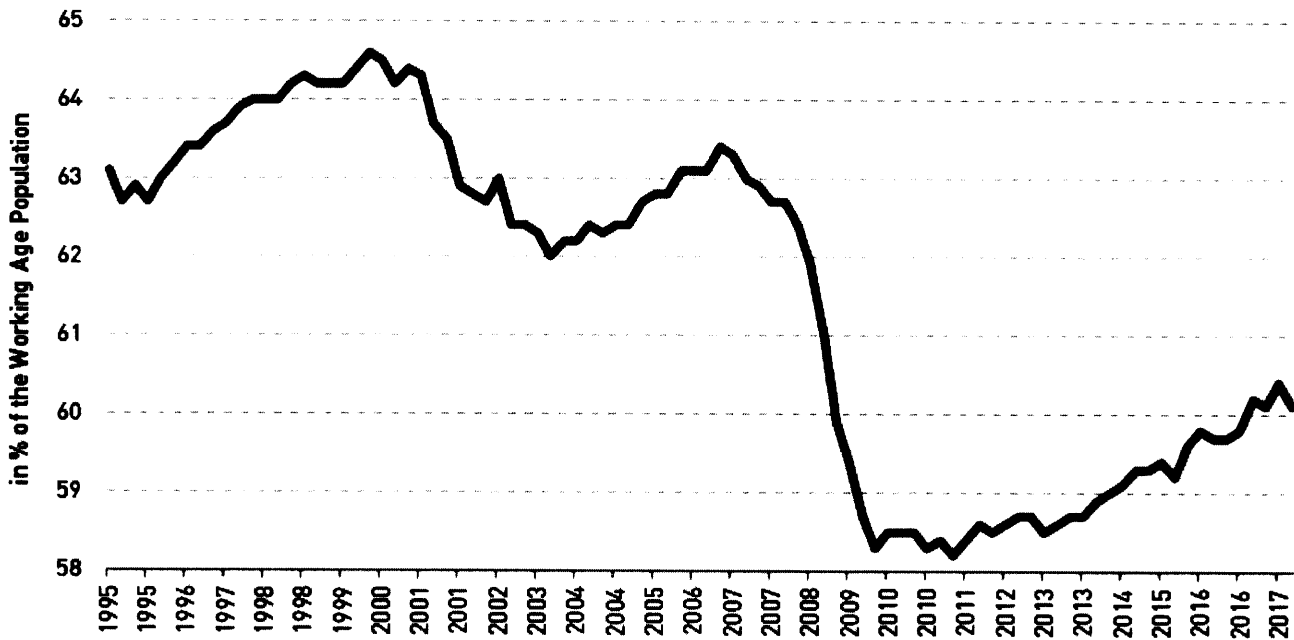
That brings us to inflation. In our view, the transition from unhealthy low disinflation (or outright deflation) to balanced conditions (which we call reflation) is still occurring. So while prices are gradually accelerating, the nascent capability cycle is gathering productivity benefits. The combination of earnings growth and gradually rising rates augers well for the continuation of the capability cycle as well as for growth assets.

Given all this, we believe investors should own asset classes whose cash flows will benefit from this environment. These include financials and the providers of the capability cycle: cloud computing companies, fintech enablers, and automation process providers. Fixed coupons need to compete with a rising rates curve, but accelerating cash flows can outrun the rates curve. Our view is that creative destruction has time on its side and will win over wage-induced inflation.

At a macro level, stepped-up investment will help accelerate growth, and supply-focused growth will help keep a lid on inflation. At the micro level, this will be accompanied by significant resets to business models as well as potential recalibration to what constitutes neutral levels in rates and inflation. We think this is a good time for investors to be more flexible in their beta allocations and more active in their security selections.

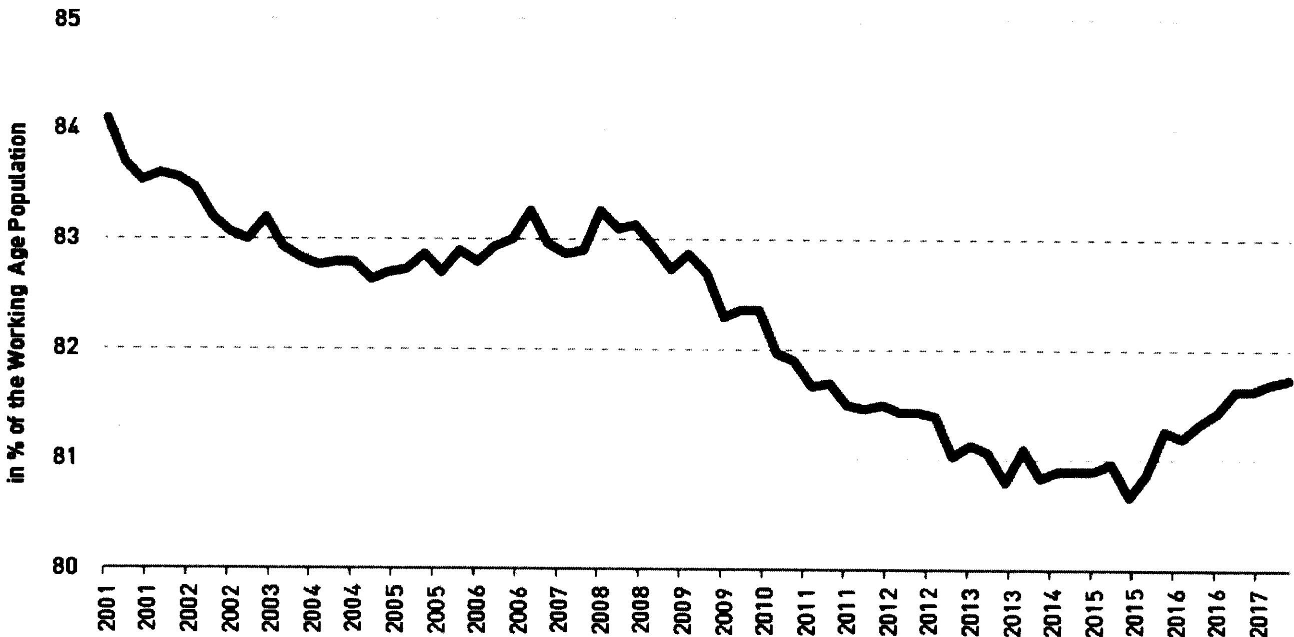
The Labor Participation Rate Is Still Recovering and Has a Long Way to Go

Employment to Population Ratio



Source: Bloomberg, BLS, and PineBridge Investments as of 8 January 2018.

US Participation Rate Prime Age (25-54)



Source: Bloomberg, BLS, and PineBridge Investments as of 8 January 2018.

Disclosure:

Investing involves risk, including possible loss of principal. The information presented herein is for illustrative purposes only and should not be considered reflective of any particular security, strategy, or investment product. It represents a general assessment of the markets at a specific time and is not a guarantee of future performance results or market movement. This material does not constitute investment, financial, legal, tax, or other advice; investment research or a product of any research department; an offer to

sell, or the solicitation of an offer to purchase any security or interest in a fund; or a recommendation for any investment product or strategy. PineBridge Investments is not soliciting or recommending any action based on information in this document. Any opinions, projections, or forward-looking statements expressed herein are solely those of the author, may differ from the views or opinions expressed by other areas of PineBridge Investments, and are only for general informational purposes as of the date indicated. Views may be based on third-party data that has not been independently verified. PineBridge Investments does not approve of or endorse any re-publication or sharing of this material. You are solely responsible for deciding whether any investment product or strategy is appropriate for you based upon your investment goals, financial situation and tolerance for risk.

This information is for educational purposes only and is not intended to serve as investment advice. This is not an offer to sell or solicitation of an offer to purchase any investment product or security. Any opinions provided should not be relied upon for investment decisions. Any opinions, projections, forecasts and forward-looking statements are speculative in nature; valid only as of the date hereof and are subject to change. PineBridge Investments is not soliciting or recommending any action based on this information.

Disclosure Statement

PineBridge Investments is a group of international companies that provides investment advice and markets asset management products and services to clients around the world. PineBridge Investments is a registered trademark proprietary to PineBridge Investments IP Holding Company Limited.

For purposes of complying with the Global Investment Performance Standards (GIPS®), the firm is defined as PineBridge Investments Global. Under the firm definition for the purposes of GIPS, PineBridge Investments Global excludes some alternative asset groups and regional legal entities that may be represented in this presentation, such as the assets of PineBridge Investments.

Readership: This document is intended solely for the addressee(s) and may not be redistributed without the prior permission of PineBridge Investments. Its content may be confidential, proprietary, and/or trade secret information. PineBridge Investments and its subsidiaries are not responsible for any unlawful distribution of this document to any third parties, in whole or in part.

Opinions: Any opinions expressed in this document represent the views of the manager, are valid only as of the date indicated, and are subject to change without notice. There can be no guarantee that any of the opinions expressed in this document or any underlying position will be maintained at the time of this presentation or thereafter. We are not soliciting or recommending any action based on this material.

Risk Warning: All investments involve risk, including possible loss of principal. Past performance is not indicative of future results. If applicable, the offering document should be read for further details including the risk factors. Our investment management services relate to a variety of investments, each of which can fluctuate in value. The investment risks vary between different types of instruments. For example, for investments involving exposure to a currency other than that in which the portfolio is denominated, changes in the rate of exchange may cause the value of investments, and consequently the value of the portfolio, to go up or down. In the case of a higher volatility portfolio, the loss on realization or cancellation may be very high (including total loss of investment), as the value of such an investment may fall suddenly and substantially. In making an investment decision, prospective investors must rely on their own examination of the merits and risks involved.

Performance Notes: Past performance is not indicative of future results. There can be no assurance that any investment objective will be met. PineBridge Investments often uses benchmarks for the purpose of comparison of results. Benchmarks are used for illustrative purposes only, and any such references should not be understood to mean there would necessarily be a correlation between investment returns of any investment and any benchmark. Any referenced benchmark does not reflect fees and expenses associated with the active