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Global Markets

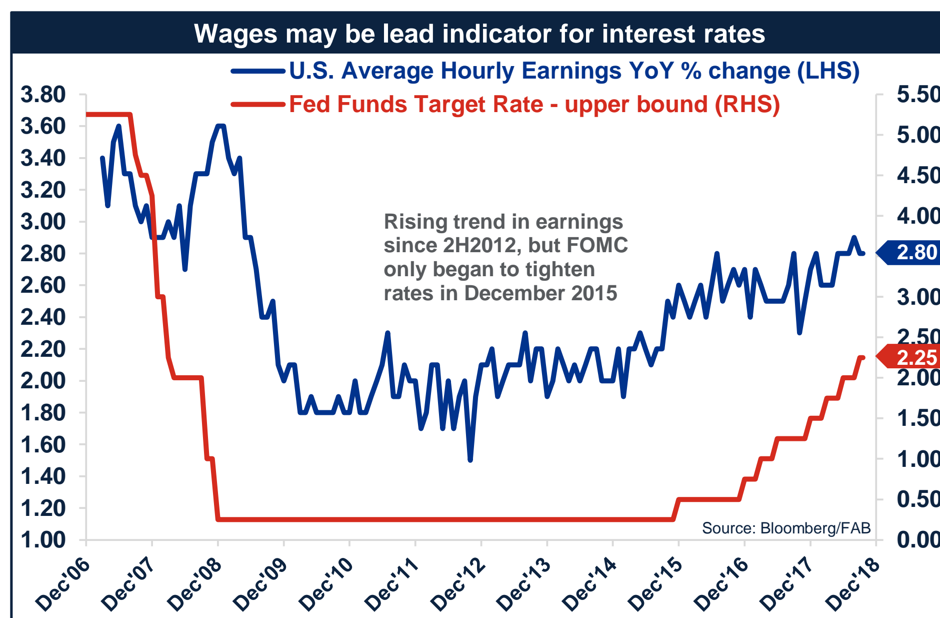
Wage growth: A clear and present danger

A recurring and increasingly pressing theme in recent client strategy meetings has been the outlook for global rates and within this, the role of inflation. With major central banks (Federal Reserve, European Central Bank, Bank of England) now either on, or shifting toward, an interest rate tightening trajectory, inflation is of course a key factor in future rates market expectations. And the latter has direct implications and ramifications for asset allocation strategies as we head toward 2019.

Until now, inflationary pressures have been relatively well anchored, allowing central banks the freedom to follow a measured pace of – or timetable toward – tightening, while aiming to achieve a symmetric and sustainable 2% inflation objective. Tightening labour markets could change this.

Wage growth, or relative lack thereof, has generally been the missing link in the global inflation equation up until now. In turn this has helped to restrain interest rate tightening expectations.

Moderate wage growth trends have helped to keep aggregate inflation low, but in recent data we have begun to see signs that this could be about to change, thereby fueling more hawkish undertones in the market. The prospect of wage growth may figure high in a consumer happiness index, but it could also give central banks the excuse to call an end to the monetary accommodation party and ratchet interest rates higher.



To this end we note that wage growth is beginning to show upward momentum in the U.S. and Europe, although we would caution that all labour cost increases are not necessarily made equal. For example, while average per worker earnings or average hourly earnings have clearly been strengthening over the past two years, unit labour cost growth (wage growth adjusted for productivity growth) has remained broadly flat over the same period.

Nonetheless, in aggregate the global labour market is showing clear signs of tightening, with wages biased to the upside, which could feed hawks' rhetoric between now and early/mid 2019. Such a scenario adds weight to our expectation of a higher-than-currently-priced-in interest rate environment as we head into 2019.

22nd October 2018

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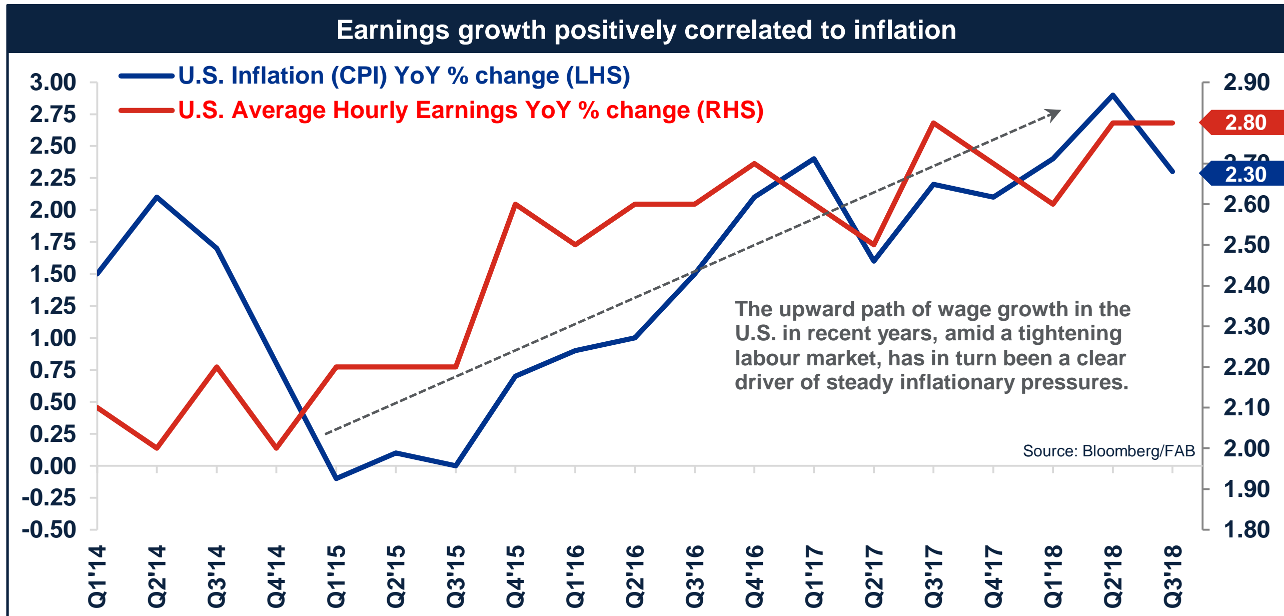
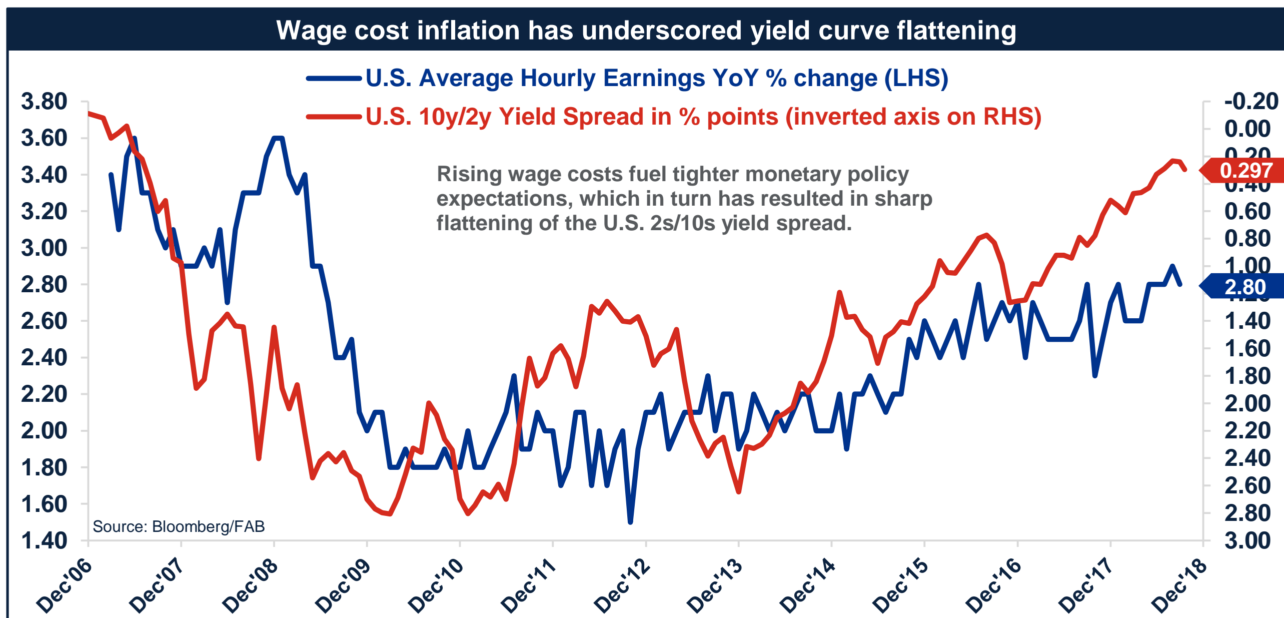
U.S.

September average hourly earnings ran at a firm +2.8%, albeit down modestly from the +2.9% seen the prior month (where August was at a 9-year high), so in our opinion wage inflation clearly seems biased to the upside.



Meanwhile core U.S. CPI was +2.2% in September (unchanged from August), but core PPI (ex food and energy) ticked up from +2.3% in August to +2.5% last month – both comfortably above the Fed's symmetric inflation target of 2%.



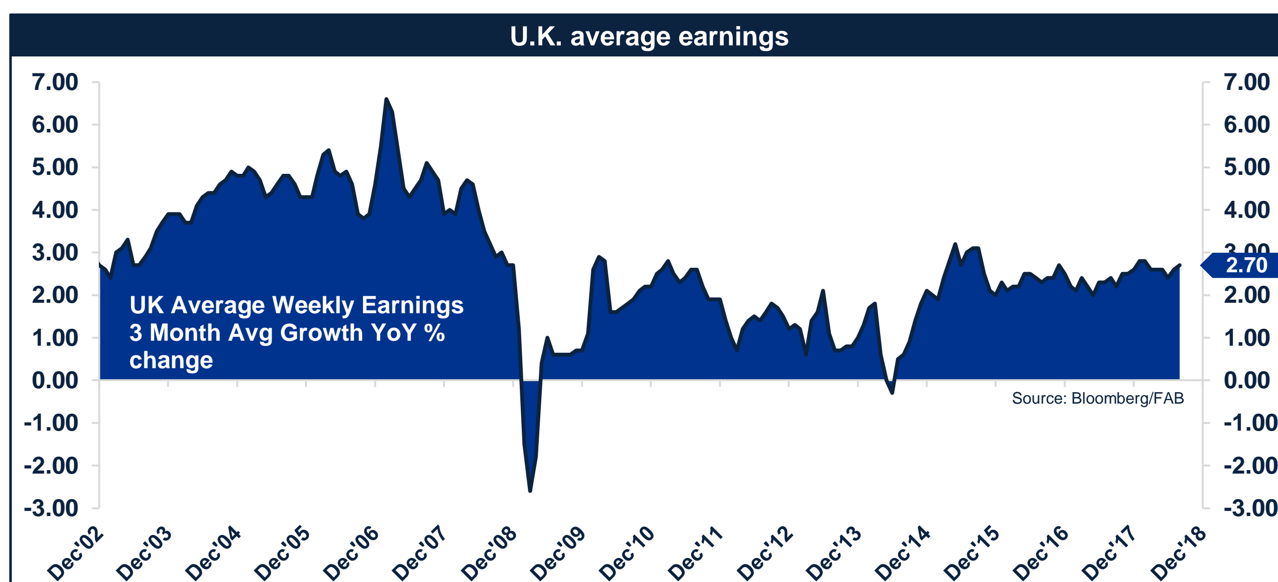
U.K.

Likewise, while core inflation (CPI) in the U.K. appears reasonably well anchored for now, albeit floating around the Bank of England's 2% target level, it is again wage growth expectations that may be the key foundations of future inflationary pressures.

Core CPI came in at +1.9% in September, moderating slightly from the +2.1% seen in August and well below the +2.7% rate registered in 2H2017. The hawkish outlier was PPI, which rose +10.3% in September, above the expected +9.2% and meaningfully stronger than the +8.7% seen in August, but to put this in context, we would conjecture that the current strength is largely attributable to higher oil prices.

But tightness in the U.K. labour market is also underpinning a hawkish outlook, centered on the current 4% unemployment rate, the lowest in 43 years. Moreover, with the BoE having hiked in August, despite all the current uncertainties surrounding Brexit, we believe they have made their longer-term intentions clear. Labour market strength, quietly fueling an upward bias in wage growth, therefore justifies close monitoring.

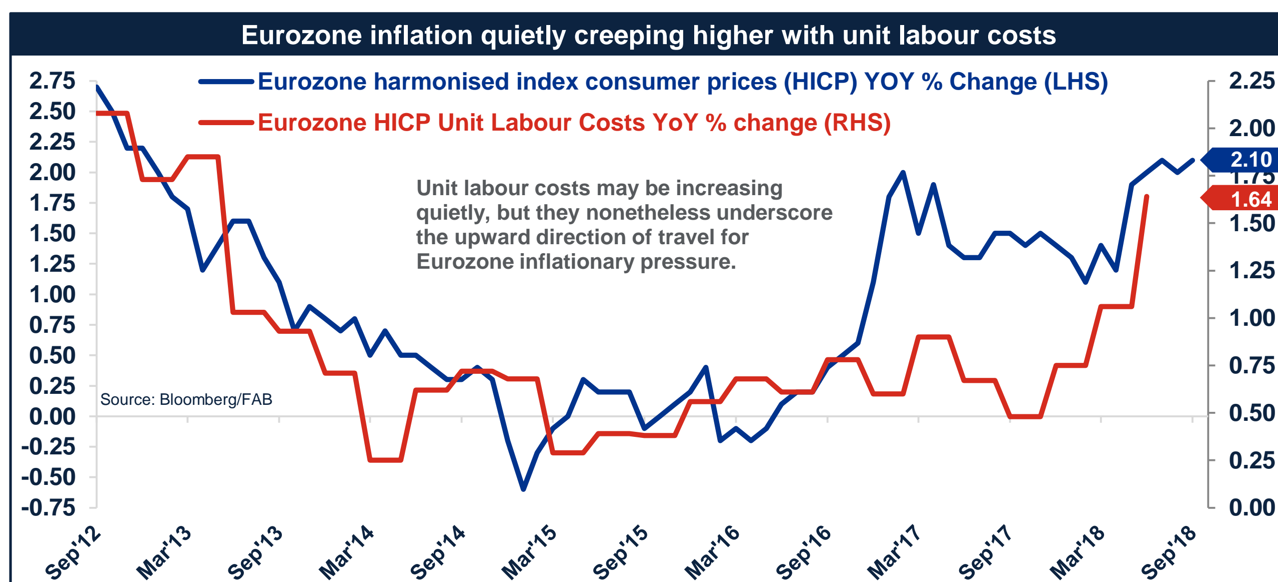
Indeed, we note that latest estimates from the Office of National Statistics (ONS) show that average weekly earnings in the U.K increased by 3.1% YoY in nominal terms, excluding bonuses, for the 3 months to August, and by 2.7% YoY including bonuses. In real terms average weekly earnings rose 0.7% YoY, excluding bonuses, and by 0.4% YoY including bonuses.



Eurozone

With Eurozone unemployment running at 8.1% in August, there is less of an obvious tightness to labour market conditions in the region. However, while unit labour cost growth was +1.6% as of Q2 2018, we note that this represents a not insignificant rise from the +0.5% growth registered in Q3 2017.

Moreover, we would suggest that this modest rise in wage expenses has been feeding upside momentum in Eurozone inflation. The Eurozone harmonized consumer price index (HICP) rose 2.1% in September, from 2.0% in August, and a significant turnaround from the recent historic low of -0.6% (deflation) registered in January 2015.



Inflation in the Eurozone is also being fanned by external, non-domestic factors, most importantly the current strength in the oil price. In this respect, we note that Euro area PPI rose +4.2% in August, with July's figure revised higher to +4.3% from the prior 4.0% release.

This said, the nascent level of balanced economic growth and still elevated unemployment suggest that the upside risk to inflation in this area should remain reasonably contained for the foreseeable future.

Indeed, the European Central Bank now expects headline inflation to be around +1.7% through to 2020. This modest price appreciation over the next 2 years is expected to be underpinned by gradual economic expansion, high levels of capacity utilization, regional pockets of labour market tightness and therefore rising wage growth. As such, the outlook for wage growth inflation will be key to the ECB achieving its annual inflation targets. Market Insights & Strategy

Conclusion: Wage growth is key

Global markets are still pricing in a gradual pace of (further) monetary tightening by the Federal Reserve, even as inflation data and outlooks remain reasonably anchored. Moreover, the expectation of further FOMC rate rises – with an additional 25bp increase is seen in December and then at least 2 or 3 further rises in 2019 – comes after the 8 hikes already executed since the end of 2015.

With tighter monetary policy having failed to meaningfully dampen U.S. labour market strength, the jobs market continues to tighten with the U.S. unemployment rate at a near-50 year low, we believe that wage growth inflation could be the key trigger to more hawkish central bank rhetoric over the coming quarters. Developed and emerging market credit and equity markets would not respond well.

Analysis of labour market data across the U.S., Eurozone and U.K. suggest that an increase in wage growth inflation could already be underway. With increased momentum, this could provide central banks with a welcome excuse to accelerate their monetary policy and balance sheet normalization strategies. Such an outcome would be a clear and present danger for risk appetite and global risk asset performance during the course of 2019 and beyond.

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