

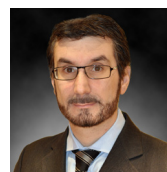
# Pacific States of America

## Economist Insights

The market appears to believe that developed market economies are at serious risk of 'Japanification' – a lengthy period of very weak growth and inflation close to zero. This is very apparent when looking at the collapse in long term inflation expectations. But is this risk of 'Japanification' really justified by fundamentals or is it just the result of transitory market fears?



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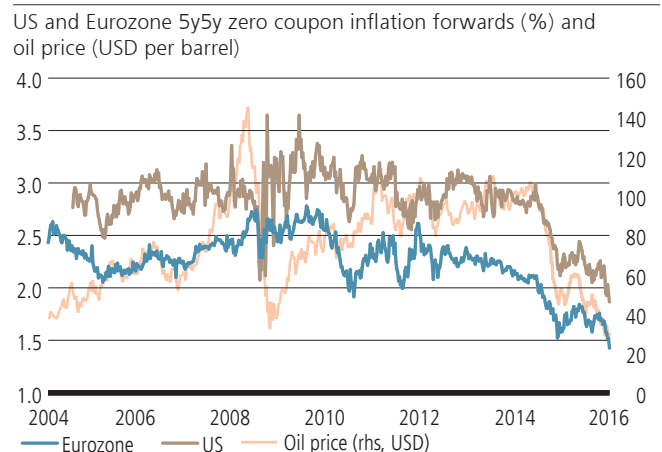
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A novel from the 60s, called "The Man in the High Castle" recently became a successful TV series. In this novel's alternative reality we see the US split between Germany and Japan, with the west coast renamed the "Pacific States of America". It has been said that life imitates art, and at the moment it appears that markets are imitating art by pricing in a 'Japanification' of inflation in the developed world, particularly the US and Eurozone.

The market expectations for a 'Japanification' of these economies is clear from the developments in long term expectations in the Eurozone and the US; they resemble the correction that we saw in Japan when it entered the so-called lost decade (ten years of very weak growth and inflation close to zero). There are different measures of inflation expectations, with some being taken from consumer surveys and based on their expectations for future inflation. One problem with this approach is that consumer expectations tend to be influenced by current inflation. Inflation is meant to be also driven by inflation expectations, but the surveys look more like lagging than leading indicators.

For this reason, many central banks prefer a market-based measure of inflation expectations, the so called 5y5y inflation forwards. This measures financial markets' expectations for average inflation over the 5 years starting 5 years from now (i.e., inflation in years 5 to 10). And because it looks at inflation expectations in the future it should be more stable and not influenced by the short term fluctuations of oil or food prices. In general, market based inflation expectations tend to be higher than the central bank inflation target. This mainly reflects the term and liquidity premium (most inflation linked instruments are less liquid than sovereign bonds) and has nothing to do with central bank credibility.

**Chart 1: Deflated capitulation**



Source: Bloomberg LP Finance

Since the second half of 2014 5y5y inflation forwards have collapsed in both the US and the Eurozone, reaching levels not even seen in the aftermath of the financial crisis when it felt like the world was coming to an end (see chart 1). While the fall in the Eurozone has been more progressive, the collapse in the US seems quite surprising.

Now, if in theory (and historically) 5y5y inflation forwards have a very low correlation with movements in the oil price, it looks like the recent drop in expectations has come hand in hand with the collapse in the oil price since mid-2014. In itself, this is preposterous: if an oil glut is pushing down oil prices today, by itself that reduces the likelihood of a glut 5-10 years from now. But if instead it is deflation fears that are driving both inflation expectations and oil prices down, then both the Fed and the ECB are in big trouble. Fears of a slowdown in emerging markets could also have played a role. However, it is still hard to believe that this slowdown will have a permanent effect on US and Eurozone inflation.

Admittedly, if we look at the fundamentals of the Eurozone economy, the more gradual drop in inflation expectations could be well associated with the risk of a downward shift in trend inflation. Eurozone core inflation (inflation excluding food and energy prices) has been well below the pre-crisis average since 2009 (and is currently about half the ECB target). Wage growth is very low not just in the periphery but also in the core countries. And finally, the ECB reaction function has been well behind the curve relative to other central banks. Nonetheless, some of the currency effects brought about by the recent ECB policy easing are currently being neutralised by similar actions from other central banks, especially in Asia. It is not then that surprising that the market is pricing in the risk of Eurozone inflation remaining very low for years to come.

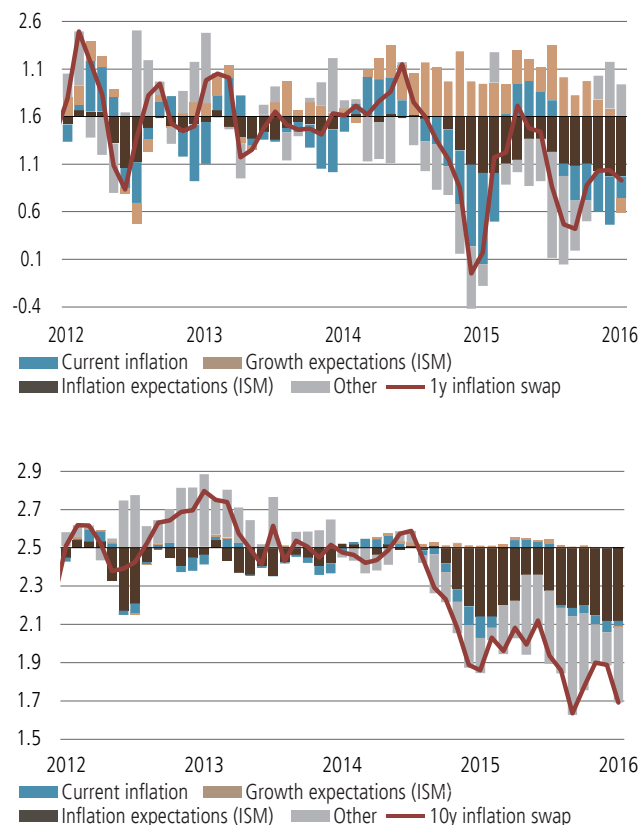
On the other side, the drop in US inflation expectations does appear rather puzzling from a fundamental perspective. Core inflation (CPI) is not only at its pre-crisis average but also well above short term and long term market expectations. At the same time the domestic component of CPI in the US is much larger than in other countries given the large weight of the housing sector (especially rents) in the inflation basket. This makes US inflation much less affected by import prices and exchange rate movement. As long as the labor market continues to recover, there should not be much risk of a collapse in core inflation. So what is driving market inflation expectations in the US?

Market inflation expectations should depend on a few macro and market factors: current inflation, the growth outlook and, of course, the inflation outlook. Furthermore, there are other market factors such as liquidity, term premium, etc., and they have differing importance for different expectation horizons. For instance, current inflation and the growth outlook tend to be more important over the short term while the inflation outlook is more relevant for longer dated horizons.

By proxying the growth and inflation outlook with business expectations for growth and inflation it is possible to get an idea of how those factors have influenced inflation expectations so far (chart 2). While 1-year inflation expectations seem in line with fundamental drivers, it appears that a large proportion of the current level of 10-year inflation expectation is not currently explained by fundamentals.

**Chart 2: Inflating the unknown**

Determinants of 1y and 10y inflation swap implied inflation



Source: Bloomberg LP Finance, BLS, Institute for Supply Management, UBS Asset Management

In truth, this is not the first time that has happened. However, most of these deviations tend to be market shocks or fears that have transitory effects. For instance, the 'unexplained' pick-up in inflation expectations in 2013 was caused by the unexpected announcement of Fed tapering.

The current deviation seems to be more related to the markets' belief about the permanent effects that the fall in oil price and weakness in emerging markets could have on the US economy. For this reason, it seems that financial markets are pricing in a recession that is nowhere near to the data (with the exception of the manufacturing sector of course). Yet it seems likely that, as in the novel, reality may reassert itself.