MARKETS HAVE GROWN TOO OPTIMISTIC: THE CARL LEWIS EFFECT HAS TAKEN HOLD

Seaford Macro Update
January 2023

- Recent data releases from G7 economies broadly confirm the course we anticipated in our November 2022 paper on the new global inflation regime, namely
  - Headline inflation continues falling
  - Core inflation is, however, proving to be sticky
  - The job market remains robust; real wages continue improvement towards turning positive
  - Strength in the job market will continue to support demand, ensuring most developed economies stay out of recession, or at most enter short and shallow recessions
- Markets have welcomed recent inflation reports enthusiastically; as headline inflation continues falling, a narrative has taken hold that the worst has passed, inflation will return to the status quo ante, and central banks will soon 'pivot' towards reductions in interest rates and an end to quantitative tightening
- We disagree with this analysis; we predict that core inflation will fall much more slowly than markets currently expect, and that as a result the declines in headline inflation will slow in the course of the year; barring shock-induced major recessions, we do not expect inflation to ever return to pre-pandemic levels
- As a result, we expect interest rates to continue rising; the current rally in bond yields will reverse; other asset markets will then follow
- The reason for the persistence of core inflation is what we have called the Carl Lewis effect – the fact that after a late start, wages rose sharply and will now hold their gains as headline inflation keeps falling; in most economies (the UK being a possible exception), they may turn positive this year
  - As the graphs at right show, the Carl Lewis effect is most visible in the USA and Canada, where in some segments of the job market, real wages have already begun to turn positive; in Japan, real wages have risen sharply and are already positive
  - The effect is weaker in the United Kingdom, but as we noted in an earlier paper, this is due to the distortion of the labour

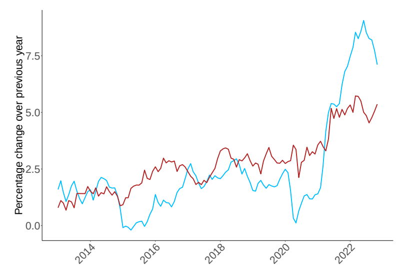

Figure 1: Headline inflation and wages in USA. In this, and all following plots, headline inflation is shown in in blue, while wage growth is shown in red.

Figure 2: Headline inflation and wages in Canada

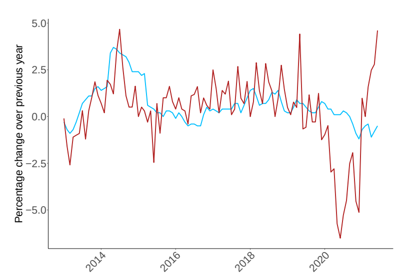

Figure 3: Headline inflation and wages in Japan

market by the UK government

  - The effect has, however, yet to show up in Italy
  - We do not subscribe to the wage-push inflation thesis, for which we find no basis; on the contrary, wage growth has been strongest where inflation is falling most rapidly
  - Instead, as can clearly be seen, wages are merely responding to the surge of inflation; instead, the increased bargaining power of labour, which is behind the strength in job markets (as our Inflation report showed) will provide a floor under which inflation will not easily fall

- Central banks will thus continue their monetary tightening policies. There is a rising possibility that in the course of the year, central banks will gradually move away from their current inflation targets to slightly higher rates; but even allowing for this, more tightening than markets currently anticipate should be expected
- That, in turn, will continue to depress asset values; record profit margins are thus set to continue contracting
- Given the persistent strength in labour markets, we therefore expect the bulk of disinflation to fall on asset values and profits; accordingly, the current risk-on rally in markets is likely to prove short-lived.

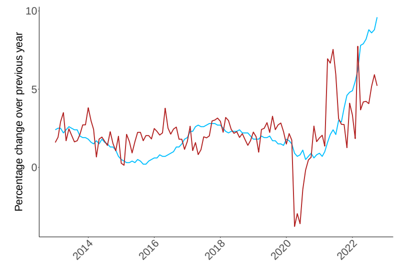

Figure 4: Headline inflation and wages in the UK

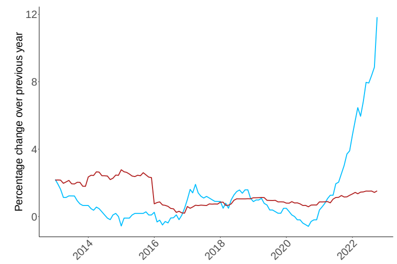

Figure 5: Headline inflation and wages in Italy

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