Juliette Declercq: Update on Immaculate Disinflation Thesis

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Erik: Joining me now is JDI Research founder, Juliette Declercq. Juliette prepared a slide deck for today's interview. Registered users will find the download link in your research roundup email. If you don't have a research roundup email, just go to our homepage macrovoices.com. Click the red button above Juliette's picture that says looking for the downloads. Juliette, it's great to have you back on the show. This is our first interview of the year. And I know that you've had some really terrific calls this year. So, let's start by going through some of your recent analysis and recommendations.

Juliette: Yes sure. Thank you very much for inviting me back, Erik. Well here we are – midway through 2023. And do you know what I see? Headline inflation vanishing in a puff of smoke, and no hard landing. The rise and fall of this pandemic-induced price rollercoaster was a perfect response to the Keynesian AD-AS (Aggregate Demand - Aggregate Supply) model. And that is the very reason I could call for "immaculate" disinflation all the way back in September 2022. See those hours siting on a bench at uni learning about macro models did pay in the end. Here is how it works (see chart 1 in the chart package). The supply curve is convex; firms need increasingly higher prices to increase output when spare capacity is exhausted. In contrast, the demand curve is concave for products with "inelastic" demand. If you struggle to find alternatives, you will pay more; think of European energy in 2022. In 2021, Keynes' prophesy cooked up a perfect storm: the negative supply shock combined with a positive demand shock to force prices into a new equilibrium on the steep (inelastic) parts of both curves.

Spare capacity was limited, and demand was relatively "inelastic" (sure, we had a load of cash, but what services could we blow it on?). So, while global output only edged up (Qo to Q1), it sent inflation through the roof (Po to P1). What happened next was about what you would expect. Everyone on the supply side suffered a massive bout of FOMO and started stockpiling like crazy. Inventories of raw materials, finished products and workers hit record levels. And that, as I argued back then, turned the pandemic famine into a feast. The problem was nobody wanted to eat anymore, they wanted to dance. So, I argued, the initial negative supply AND positive demand shocks would reverse, leading to "immaculate" disinflation: a resumption of the initial burst of inflation with no macro drama – price pressures to subside eventually with output and employment practically untouched. And that's pretty much what happened. So looking on to chart two, you can see that the record inventory build up, pull the U turn. You can see on charts, three that extreme geopolitical tensions peaked pretty much in September last year, and that collapsed the premium the geopolitical premium on commodities back to fair value. And in the end, you can see on top for that a supply demand imbalance, mirroring the COVID shock turned tremendous manufacturing inflation into actually manufacturing deflation according to the last PMI numbers. So here we are, goods price pressures have largely evaporated. If we consider last week PCE reports, we can see that the feds preferred inflation gauge, which is the PCE deflator dropped to 3.8% year on year in May, from 4.3% in April. And if you look at the three months, on a three month basis, we're actually at 2.45% annualized which is actually approaching the 2%. Target.

Erik: Okay, so the narrative rightly called the inflation trends. But you're saying that today, the real question is not that inflation. But what scars has that inflation left on the Goldilocks economy that we had before

Juliette: Indeed, and that's obviously the crucial point going forward, for the Fed, and generally for all central banks, and obviously, for what matters to us all which is asset prices. So if you're taking chart five, you can see that the initial headline inflation shock, spreads through wages to domestically set prices. So considering core services ex-housing, which Powell and markets favorite gauge, we've been running around 4.5% year on year for the past 18 months. And we only just recently dropped from 5% to 4% on the three months basis in the past quarter. I think we can say, with good credibility that if the budding drug trends persist, the Fed will likely stay put and pat themselves on the back for tightening policy enough. So we're definitely close to the end of the rate hiking cycle. But really, what's interesting is wages and surprisingly given our key future wage settings will be for the outlook. It was a subject that was covered in Sintra, so the ECB meetings in Sintra by the Bank of England Silvana Tenreyro. Now she's got a notorious dovish bias. But with that in mind, she still had a really, you know, good argument that a central bank should react not to the initial price shock, but only to the spill overs to wages and domestically set and that's mostly services prices. I'll quote exact words here, because it's exactly the way policymakers will react in coming months. So it really describe Central Bank's reaction function in the future accurately.

She said quote on quote, “If workers try to resist a fall in their real income by making higher nominal pay demands, and firms try to defend their real profits by raising domestically set prices, real-income resistance can lead to nominal inertia and delay the return of inflation to target.”. In other words, while I was right on the initial COVID price shock vanishing. Price pressures persist due to the classic lagged second run effects on services prices and wages. In other words, companies are resisting lower profits and workers are resisting lower real wages. And because of continued strong aggregate final demand, they both succeeded. Now I anticipated this would happen from Q3 last year. Paradoxically, global manufacturing weakness and headline disinflation is reflationary. Why? Because lower goods and resource prices have been a blessing for a large DM services sector, which benefitted from spectacular aggregate personal real income gains and, consequently, the breathtaking repricing of 2023 recession risks. As an aside, this is the reason the manufacturing leading indicators have been so spectacularly wrong in helping to call the global sector. This time, weak manufacturing strengthened the services sector rather than being a leading indicator (traditionally manufacturing drives services growth because of it is a highly cyclical sector. So you can see for yourself what happened on chart 6 that real income gains that mirrored the losses endured in 2021/22 caused a tremendous global economic rebound which was compounded by easing financial conditions as we priced out immediate recession risks.

Erik: Okay, so you're effectively saying that weak manufacturing and disinflation are the probable reasons for the repricing of rate cuts that I guess have now become rate hikes.

Juliette: Yep. That's right, Erik. And you can see on chart seven that, you know, just a few months back we had like 100-basis points plus spread between Fed funds and twos, which traditionally forces either cuts or a recession if the Fed cannot cut and this time it was a red herring. Effectively, you can also see on chart 8, that the fantastic services sector recovery in 2023 allows firms to rebuild profits opportunistically, by keeping services prices charged sticky, despite much lower input prices, and you would actually find the same is true if you're looking at like PPI versus CPI charts that will tell you exactly the same thing.

Erik: Right so this covers clearly why consensus started 2023 totally wrong footed. And it indeed explains the 2023 global activity bounce, but your expertise is the future so what happens next?

Juliette: You are right. Obviously, it's all about what happens going forward. On what happens next. The first bit of information came through just last week through the June flash PMIs, which actually started to hint at a peak in final demand, and potentially renewed services disinflation. In fact, you can see on chart nine, that firms are increasingly having to pass supplier price falls to boost their sales. And that output price inflation, which is on in orange on my chart, has actually started to edge lower again after the early 2023 slight rebound on the back of a much stronger activity. More importantly though and that's really the subject of this week fresh out of the printer did the research report. The real key to the outlook is wages. Why? Because on the corporate side, the pricing headache comes less from output prices, which are driven by firms resisting lower profits, and more from sticky input prices due to the persistent wage pressures. And you can see on chart 10. And again, that's using fresh June flash PMIs data, that the cost burdens is still for companies is still far above pre-pandemic averages.

Erik: I'm assuming that wages feed right through real income as well, which is the other reason why getting their forecast right is absolutely crucial.

Juliette: That's exactly the point, Erik. And the thing is that much like the traditional supply-demand curve we talked about earlier. Real wage inflation is also a nonlinear convex function of spare labor capacity. And that would be like the equivalent of the Phillips curve that many are talking about. In plain English, that means that real wages really start trending higher when you run out of spare workers or when unemployment hits the narrow, and that basically forces firms to bump up pay to lure workers from other companies. The issue here is that where we had COVID temporary shocks before, it's not the case for the labor market globally. So the labor supply shock is actually turning permanent for the labor market. You can see that on chart 11 and the reason is simply that baby boomers are no longer just aging, but they're actually retiring on us. So structurally, this is shrinking the labor force. We already have like 2 million workers missing in the US from the pre-COVID era. And this is actually going to worsen. So as a result, the US jobs workers gap, which is the difference between labor demand and labor supply, which I'm charting on chart 12 has hit full capacity in December 2022 and it also continues to hover around zero. And obviously it is pulling real earnings expectations higher in a catch up move to what happened in 2021 and 2022. And that's the light green line on my chart on chart 12 which is coming from like different leading indicators in the Conference Board survey.

But unfortunately or perhaps fortunately, because we should all wish for real income gains. This is not just a US narrative. And in fact, the old age-to-working age population ratio will likely explode in most of the OECD in coming decades. And that's something you can see on charts 13. And the obvious macro effects of that is that is reflationary because we will see tight labor markets and rich retirees supporting real income and spending. So tight labor markets basically support real income for workers. And retirees are the one with the wealth. And so therefore, they don't have to squeeze their spending, which overall keeps aggregate demand, much more supported then what we had pre-COVID. And in fact, tighter than expected labor markets and sticky wages are the reason why the 2023 rebound has even exceeded my wildest and deeply out of consensus 2022 forecast. And that's also the reason I've been, you know, totally right on stocks, but actually lost on fixed income. The point is that in hot labor markets, workers tend to use their strong bargaining power to recoup lost purchasing power. And as a result, increased wage demands are followed the 2021 burst and short term inflation expectations in the US. And that's with a pretty reliable across the world lag of nine months between higher inflation expectations and higher wages. However, the usual nine months lag between the former and the latter means that automatically and mathematically 2023 is seeing a strong payback for the 2021 COVID supply shock hungover in the US. And 2022 energy supply shock hangover in Europe. With the original inflation shocks in the rearview mirror and short term inflation expectations normalizing what we're actually seeing is the recent wage gains are lifting real incomes, and fueling hopes for increasing purchasing power, which overall is supporting global consumption.

Erik: Juliette, I love this chart. Do you have similar ones for other DM countries?

Juliette: I do, indeed. So if you're looking at chart 15, which is the same chart for the Eurozone. There, you can see that the wave of pay rises is yet to break for negotiated wages, but collapsing inflation expectation should see wage gains retreat in H2. If you're actually considering the overall cost index, labor cost index, which is on chart 16. You can see that we already started to cool in q1, but obviously the ECB must gain conviction on further downside before shifting its hawkish stance. If you look in the UK, which is chart 17, you can see that wage growth there is living a life of its own. In fact, it's taking its cue from still strong headline inflation, rather than falling inflation expectations. And this is obviously roaring, and it has worried the Bank of England this month, because it forms the premise of a wage price spiral, and literally suggest that the Bank of England remains far behind the curve. So you should wait before going full on long Gilts. And you've got the mirror image in Japan, on chart 18 where workers have not put a fight. And despite the sharp losses in real income triggered by the exogenous burst of global inflation, they are not insisting on nominal wage increases.

Juliette Declercq
So if you consider Tenreyro's reasoning from last week, Sintra meetings, the BOJ has actually been able to stay put an ease right to do so. And lets the yen weakened until wages actually start to pick up in line with consumer inflation expectations. So apart from Japan, the opening act of the global disinflationary process has largely been a pleasurable ride. Indeed stabilizing prices, but continued strong wage gains. Again, what is there not to like in 2023. What we've seen is basically a transition from nominal to real activity growth. And that's exactly what I expected from the second end of 2022. And it's still ongoing, both in the US, as you can see on chart 19 which is considering the New York Fed survey. You can see that real earnings expectations are still catching up to you know, what we describe a very strong labor market because the probability of losing a job has basically never been so low according to consumers. The same is actually true in Europe, if you're looking on chart 20 which is, you know, again, taking data from European Commission's consumer survey. So here I will be using the leading indicators in the consumer surveys, because I don't think there is much value in the headline, but a lot of value in the right details. And you can see that real income expectations have recovered and are still rising in the Eurozone, which means that, you know, the sort of like flush recession that we had in Europe is probably not going to last. And obviously, that's the reason why equities are still making new high, you know, despite the fact that many countries have had like, two consecutive quarters of negative growth.

Erik: Okay, Juliette so you're saying that central banks have actually unleashed positive real demand forces by weighing on headline inflation.

Juliette: Right, paradoxically and against all common sense that's exactly the point, Erik. The bottom line is that monetary tightening has done the opposite of what central banks wanted. It has lifted rather than constrained demand, and created an economic sweetspot. Now, that is obviously just temporary. But that's the story of 2023. At least the first half. Into H2, nominal wages should level off. But circular labor market tightness means that wages may have enough inertia to continue beating inflation expectations, and that would raise hope for further real income gains. Such a fit, will inevitably keep final demand elevated, and possibly delay the return of inflation to target.

Erik: Okay, Juliette. But so far, we haven't had any discussion of the most expected recession of all time, which has been everybody's favorite story of 2023. So is there still going to be this most anticipated recession of all times? Is it still coming?

Juliette: Well I mean, a recession is always coming. But obviously, the main question is when and there, I'm absolutely convinced that the answer will be in wages beyond 2023 and perhaps before then, and this is obviously something I will monitor closely for JDI clients. The fun part of this inflation will actually end and unfortunately, the unpleasant part will start. The unpleasant part is wage growth, catching down to stabilizing inflation expectations, and ending the economics sweetspot. And by then, the lagged effects of overly tight monetary policy will hit demand with full force as the effective mortgage rate for example, finally catches up on the current mortgage rates, like you can see on chart 21. At that point as well. And that's a really important thing is that the US credit impulse, which I charted on chart 22 will start to matter again. So what we've had this year was a temporary disconnect between aggregate demand and credit, simply demand did not need credit. But with real purchasing power gains in the rearview mirror, the credit drought will hit aggregate demand. Again, that's on chart 22. And lastly, I'm looking forward to the update of the top 23 with Friday's Non-Farm Payroll, but my expectation is that US rates are likely to hit 6%. Because real wage, and incomes really still only normalizing and the Fed still really doesn't need to rock the boat. So what you can see on chart 23 is that despite no labor's like. Real hourly earnings are still below 2%, which would be a level consistent with the Fed's two percent inflation target. So again, let's see what Friday brings. You know, if hourly earnings like blow above 2%, then you know we could see the case for like rates moving to 6%. But really, that's not my base case scenario.

Erik: Okay, but when real wages start pushing above 2%, don't you expect a second wave of inflation and the Fed to have to trigger a hard landing this time?

Juliette: That's obviously the $1 million question for 2024 and one that actually asked to consider the AI era as a macro game changer. You see, I've written a full report on the not on AI itself, but on the macro ramifications of cognitive intelligence supply exploding with the AI revolution. And I reach very different conclusions than consensus. My view is that while this revolution will see a productivity explosion. Firstly is likely to be just a one off. But more worryingly, it is likely to cut short the budding wage cycle for workers. So what you will do is basically inject, you know, tremendous capacity in terms of cognitive intelligence. And the reason is that the one off formidable productivity gains as a result will shift the global distribution of income further towards businesses and elite workers. So sure, the good news is that inequalities will somewhat rebalance around the median wage in line with a shrinking intellectual versus rising emotional intelligence premium. And what I'm talking about there is basically, lawyers and bankers will be worth less, but potentially, nurses will be or carers generally will be worse more. But on the whole, it is really the dividends paid by a handful of mega cap big tech companies that will mostly benefit. And as a result, the new defensive trade, I think will become long NASDAQ versus long TIPS, which is actually what I've been recommending and continue to recommend.

So for me, it's sort of like the new risk parity portfolio because obviously AI is injecting a new asset class of like, ultra long duration in the US indices. And on chart 24, you can see that the tech driven productivity revival, which finally will be on the way is not likely to benefit living standards. And that's, in fact, exactly what happened with the internet revolution. I think the AI revolution will be like the Internet revolution, but basically like with massive compounded effect. So I think that aggregate demand will start shrinking again going forward without the need for substantially higher rates. But obviously, that will depend again on the state of the labor markets and how fast we can be replaced. In fact, more likely than greater than expected hikes or greater than expected cuts ahead. Because lower inflation expectations and fading, real income gains will lay bare, the fact that interest rates are already 75 basis points too restrictive and likely to become even more restrictive as inflation and inflation expectations fall. And to show that using a modified Taylor rule, which is taking inflation expectations, instead of like headline inflation as an input. And you can see that, you know for the first time in the whole history of the index, it's actually showing that, you know, cuts are already needed.

Erik: Juliette thanks again for another terrific slide deck. But you know, you really peaked my curiosity when you mentioned that your report last month was on artificial intelligence. A subject that we've been looking very closely here at MacroVoices. I know that out of respect for your paying customers, you can't share that entire report with our listeners, but how about giving us just a kind of a high level overview of what your views are on AI and particularly the risks inherent to it. Should we be concerned that AI is going to do more damage than good to the global economy?

Juliette: So I mean on that first point. I mean on your last point, my view is clearly that, you know, you've got two possibilities. Basically, either humans fall in love with robots, which is possible. You know, I mean I am citing reports in my JDI research that show that basically a medical robot has seven times more compassion than an actual doctor. So this is clearly an issue. And for example in Italy, you know, they've basically got robots to help take care of old people. And, you know it's been so far quite successful. Obviously, China has also like deployed robots to teach kids and, you know, they're able to like read f kids are bored through their iris and basically change the program according to that. So, you know eventually, it is possible that humans fall in love with robots, and that my view of an exploding Emotional premium will in the end be wrong. But if there is an emotional premium, what you will see is basically workers in all like care sectors basically anywhere where you actually want to talk to a real human. And there is still a lot to say about the fact that humans are made to connect with humans. And this is actually what brings happiness. So my view is that the same will happen as what happened with the internet revolution, where you have prices collapsing in goods, for example, but the money and the profits made and the productivity gains in those sectors that benefited from like better distributions, basically created a pool of money, that translated into much higher prices in everything that wasn't created by the internet. And in that case, it was, you know, education, medical costs, obviously, housing, etc.

So I think the risk is that the same thing happens and that, you know, the productivity gains that you're getting, you know, in banking, medical sectors law, actually, you know, produce, like another pool of money that will translate and basically blow a bubble in anything that cannot be produced by AI. So that could be an emotional premium. But that obviously, also will relate to anything that cannot be produced by AI like commodities, land, and obviously, in the end, real estate as well. So just to be short, to summarize on your question, I think if humans fall in love with robots, then we can get like massive productivity gains, and overall much higher productivity globally. But if that's not the case, and there is an emotional premium, the only thing that will happen is basically anything that can be produced by AI will become much more important as a part of the economy. And by design, that's going to be sectors that are going to be low productivity sectors, which means that overall, we will end up with on aggregate, lower productivity and in the end, you know, lower living standards as well.

Erik: Juliette as a final topic, I'd like to move on to the situation that's evolving in France right now. As most of our listeners know, you live in London but you are French in terms of where you grew up and where your family is. Obviously, you've got some very strong connections there. The sensationalized Western media has told Americans that France right now has devolved to an absolute war zone. You couldn't go there without weapons and flak jackets. I'm guessing that's probably more press exaggeration than reality. What is the real situation on the ground in France? How bad is it in and when is it going to get better?

Juliette: Right, so I'm just to soothe your listeners, you can totally go to France this summer, and you will not see war on the streets. That being said, you know the situation is very serious. And it is, interestingly linked with immigration and the fact that, you know, drug dealing is not contained to like Paris suburbs anymore, but actually spread to the rest of France. So there is a growing number of lawless zones, where drug trafficking is exploding, not just Paris. So it makes it more and more difficult to manage. But what I really want to say is that the constant state of emergency in France is also no question linked with inequalities and what we've just discussed in that report and what may be aggravated by AI in the future. And that's obviously a subject that French people are extremely sensitive to much more than Anglo-Saxon countries where inequalities are actually much higher, but people care less. I mean, this is what the French Revolution was about. And I'm afraid that COVID-led inflation and the collapse in real learnings is no question one reason for the deteriorating security situation. I mean, the Yellow Jacket movement was about inflation. You know, in the end, what's happening in France, we are really in the subject of the big macro issues that we've been talking in that interview and which will keep driving macro forces going forward. So I would say you know, keep an eye on France because the situation is dicey and the riots are not so much about you know, the killing of Nial. In fact, you know, you ask in the streets, people don't even know why they're ransacking shops, but they're doing it because you know, there is anger there.

Erik: That's a point that's always fascinated me. What goes on in these large group protest situations where people who have, I think very legitimate gripes and complaints. They've got good reason to be upset. Okay, but what does burning your country down do to solve your legitimate gripe, it seems like this just a natural human behavior that when people get pissed off, they burn shit down and they don't really stop and think about whether that helps them or not.

Juliette: Yeah well unfortunately, I mean they feel like disenfranchised as well, right? I mean, you know, their vote makes no difference. I mean in a way that's the only way they are heard as well unfortunately.

Erik: Well Juliette, I can't thank you enough for a terrific interview. But before I let you go, I want to talk a little bit more about what you do at JDI research, because your research notes are famous for the graphs and charts they contain, which everybody loves. Thank you so much for sharing the download with our listeners for this interview. What can people expect to find at JDI research when they go check out your website, what's the URL, and what products are on offer there.

Juliette: So my website is www.jdiresearch.com. My product has not changed for the last seven years but I can tell you. I can assure you that the framework changes on a monthly basis because, you know, there is no framework that could have called, rightly, the cycles of the last seven years. So, you know, I expect that I will not be replaced by AI in the near future. Because, you know, AI only knows about the past and actually try to use my common sense to actually predict what will drive the future. And quite often, it's just about getting one thing right, and, you know, for example today, we talked about wages. You know last year it was something else. You don't need to like basically gather like 50 or 500 million of like data sets to actually get markets right. So, my product is about giving you a strong understanding of the current macro backdrop and extrapolate into the future. And I basically also connect the dots directly to the markets, which makes me you know, different than any economist will which will tell, you know, what will happen macro wise but doesn't necessarily know what it will mean for markets. So you know, I've got on the first page of each reports, my timely recommendations. I mostly focus on institutionals and family offices. I've had a few happy retail clients in the past but really my price range is more directed to institutions and family offices. I mean, I should add that I haven't changed prices for a while so you know, I'm anti-inflation, which means that you know, you get a lot of real purchasing power increase from the research over the past few years.

Erik: And Juliette, in addition to not increasing your prices, you've also been kind enough in the past to offer MacroVoices subscribers a discount, what's the story there?

Juliette: Yeah that's true. I've done that every year since you know, I've known you Erik and I will continue to honor that sort of, you know, understanding we have and I'll offer any of your subscribers a discount if they tell me that they come on your behalf or after having listened to the interview.

Erik: Okay folks, well be sure to mention MacroVoices so you can get that discount. Juliette, thanks so much for a terrific interview. Patrick Ceresna, Nick Galarnyk, and I will be back as MacroVoices continues right here at macrovoices.com