May 2024

The Great Demographic Reversal: Beyond the Great Moderation

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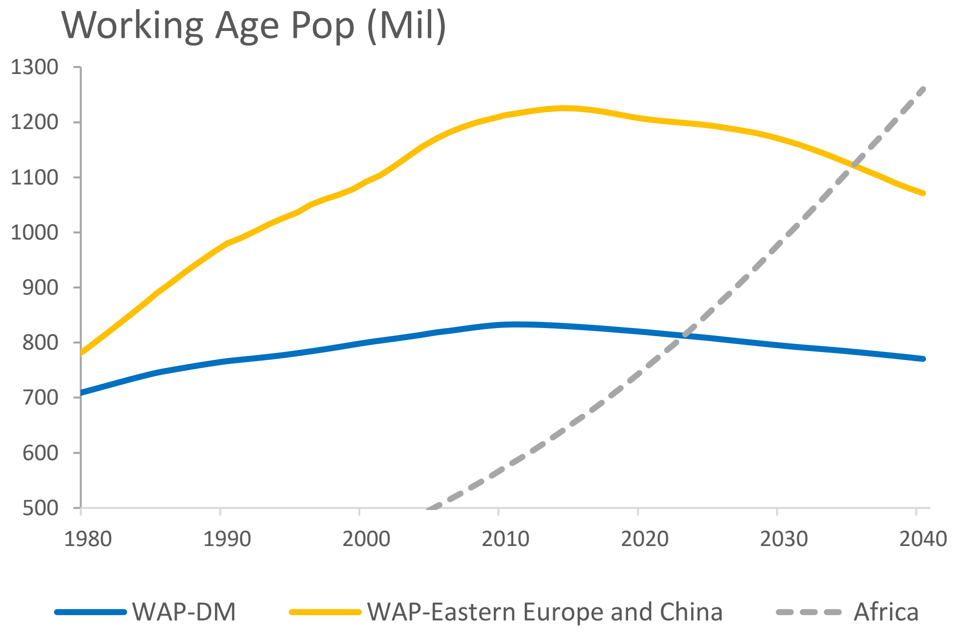
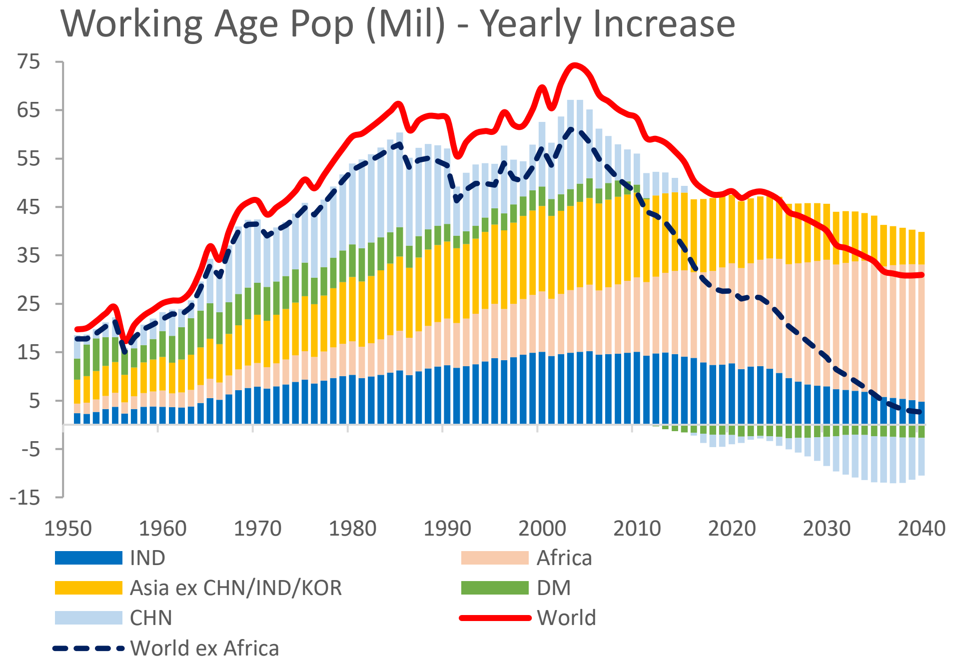
The Great Demographic Reversal – the 4 Pillars

Globalisation reversing



Workforces declining

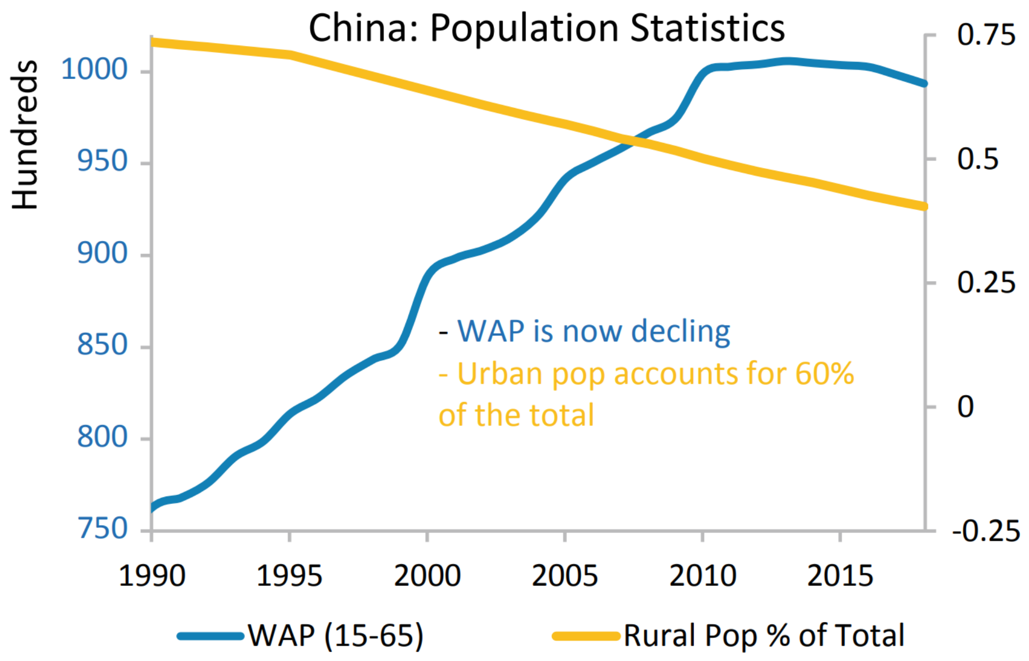


Source: Talking Heads Macro

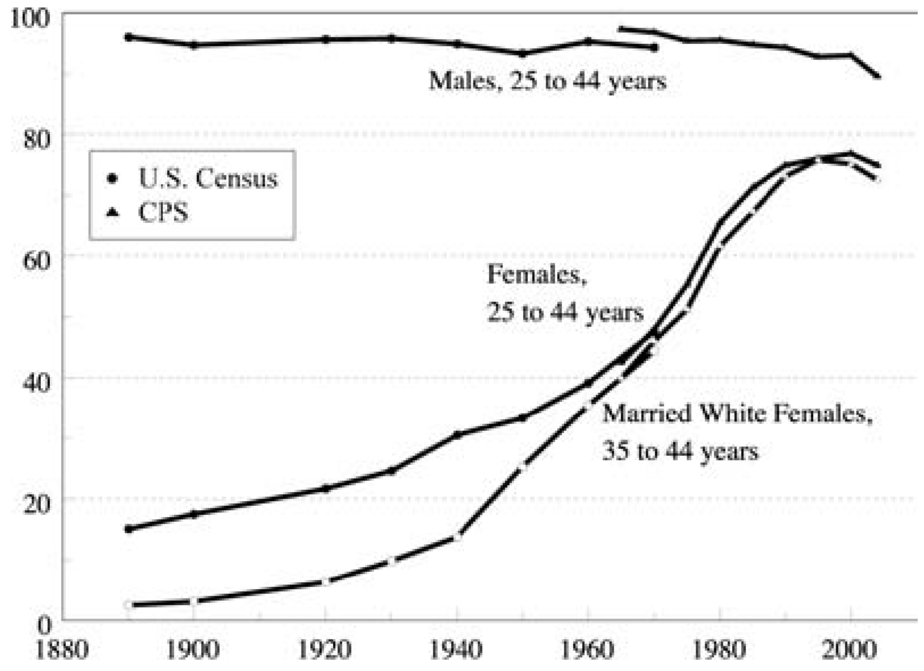
THMacro
www.talkingheadsmacro.com

The Great Demographic Reversal – the 4 Pillars

China's internal migration flatlines



Female labour force participation peaks



Source: Talking Heads Macro

Demography and Inflation: Stolper-Samuelson

Dependents (Young, Old) Consume
But Don't Produce

Dependents
Inflationary

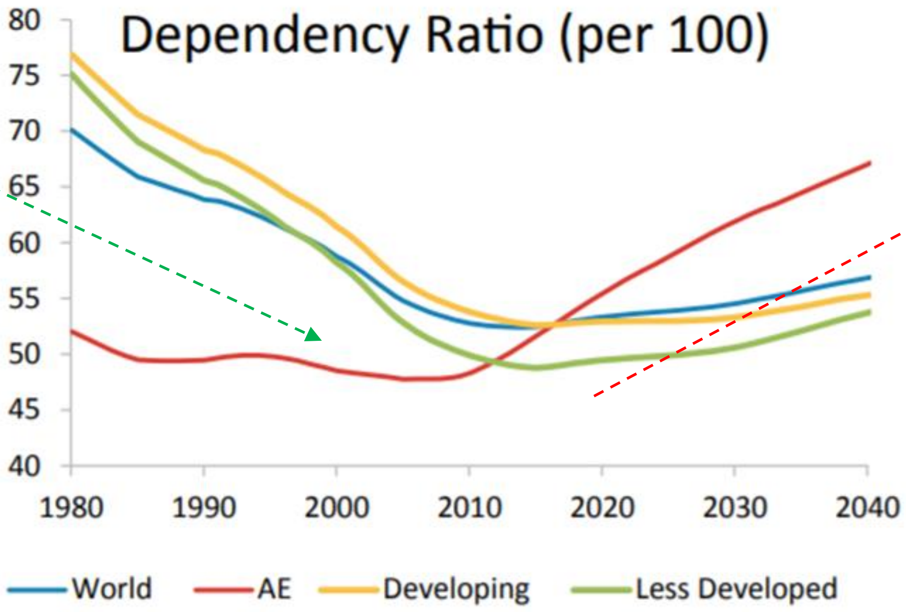
Workers Consume + Produce + Save
Wages < Production, Consume < Wages

Workers
Deflationary

More Workers
Than Dependents

=

Inflation Falls



More Dependents
Than Workers

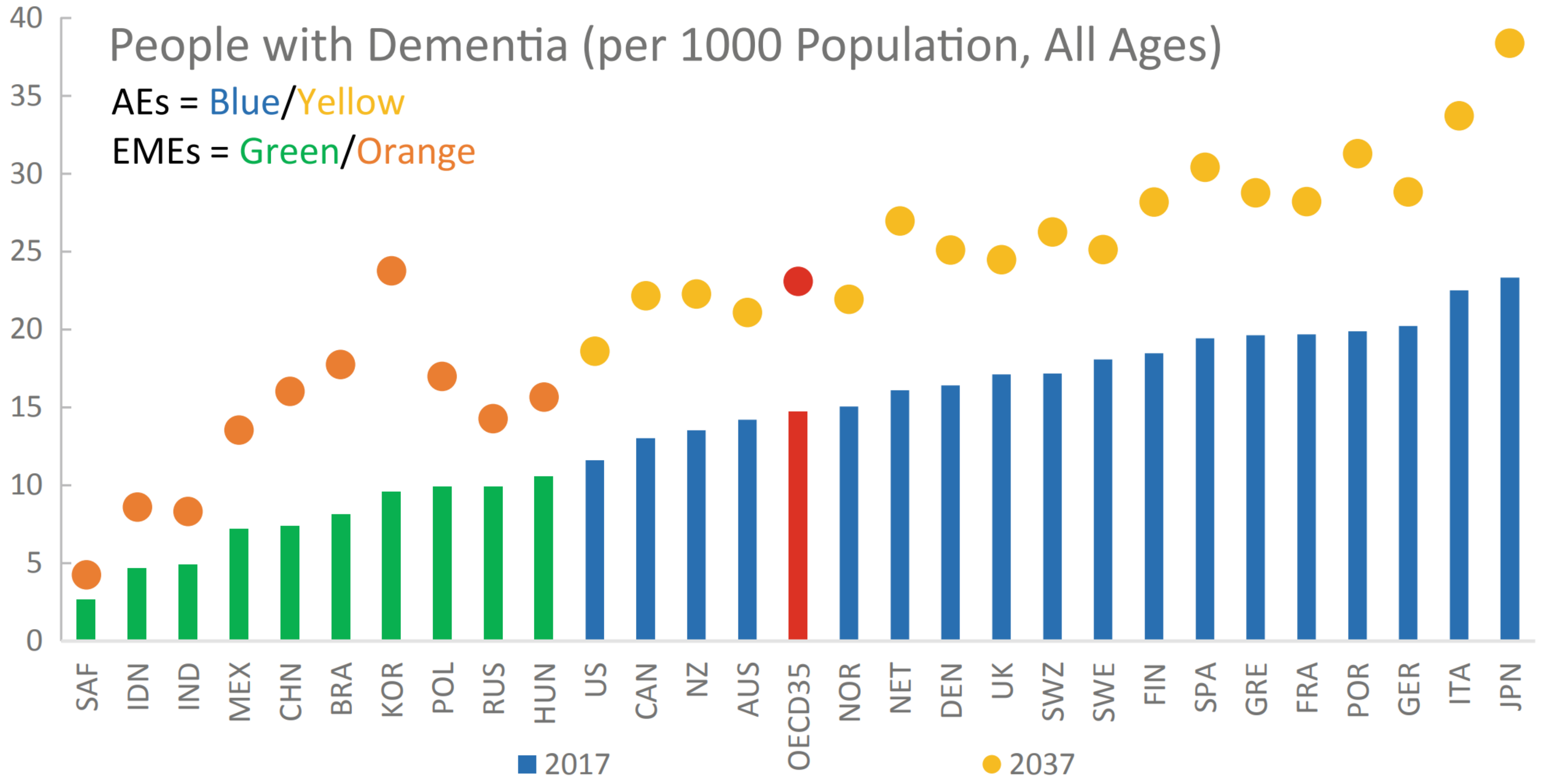
=

Inflation Rises

Source: Talking Heads Macro

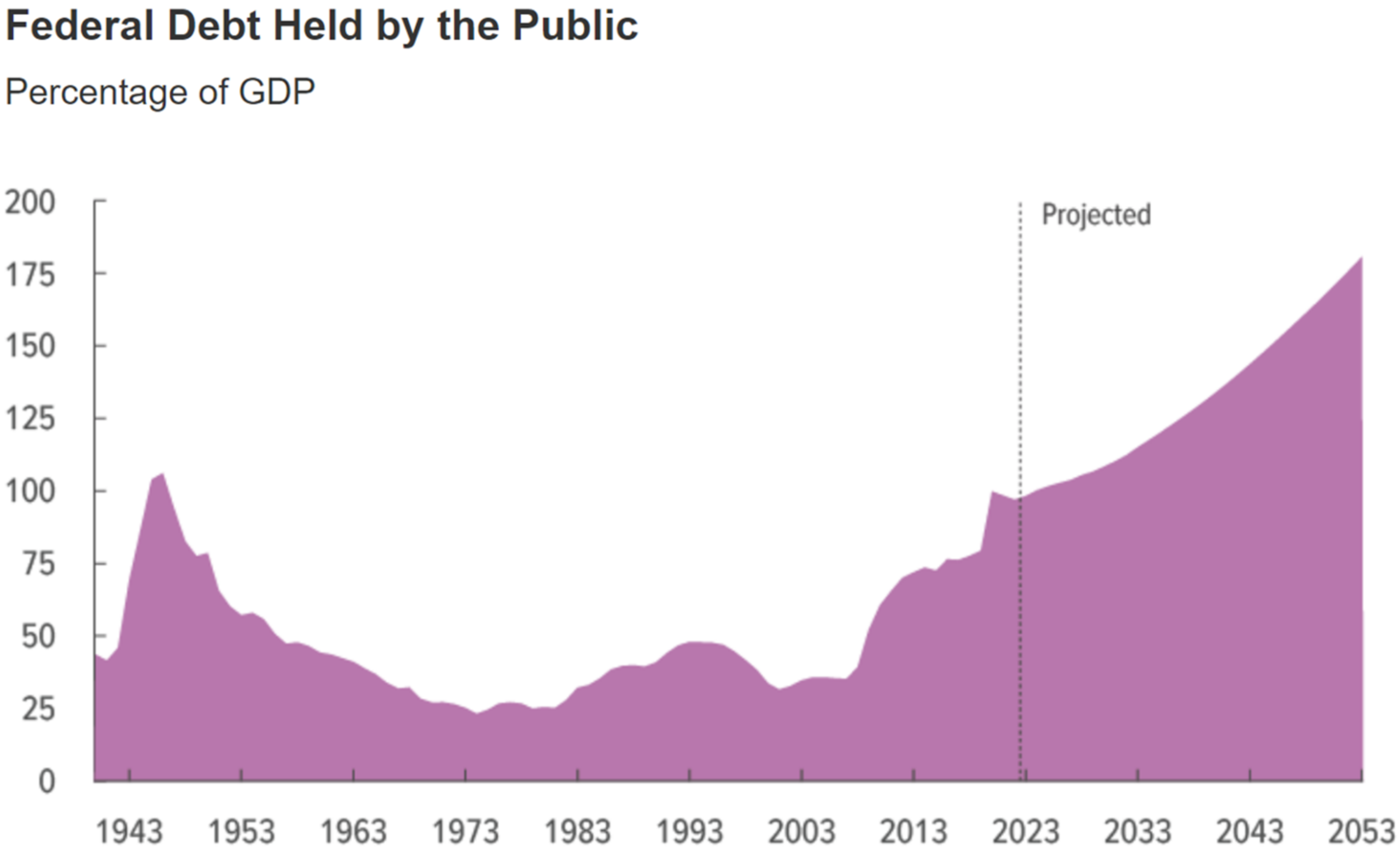
THMacro
www.talkingheadsmacro.com

Ageing Will Raise Medical Dependency and Public Debt



Source: OECD Health Statistics 2017

Steady Deficits + Steady Borrowing Rates = Rising Debt



Source: National sources, Haver Analytics, Talking Heads Macro

A Slow-Motion Mis'Truss't of Fiscal Sustainability

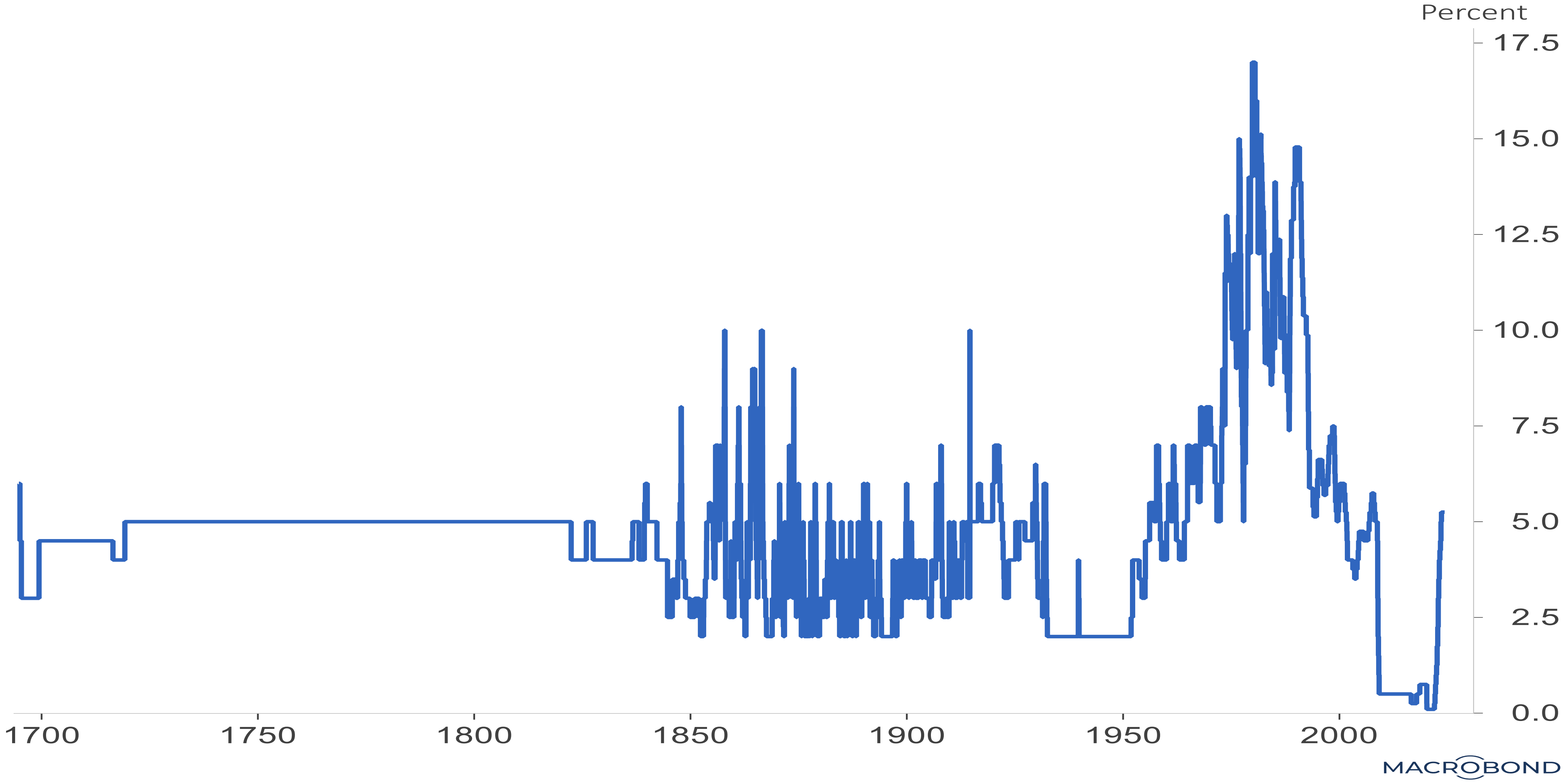
Fiscal policy:
Much higher issuance = markets demand higher interest rates

Monetary policy:
(i) Fight inflation in stable times, but support financial stability in volatile periods
(ii) Bigger balance sheet to absorb issuance, higher rates to (somewhat) fight inflation.

Fiscal sets the level of rates, monetary chooses the inflation vs *r** mix.

Source: National sources, Haver Analytics, Talking Heads Macro

A Return to Normal Rates… A 'Grey Normal'



Source: National sources, Haver Analytics, Talking Heads Macro

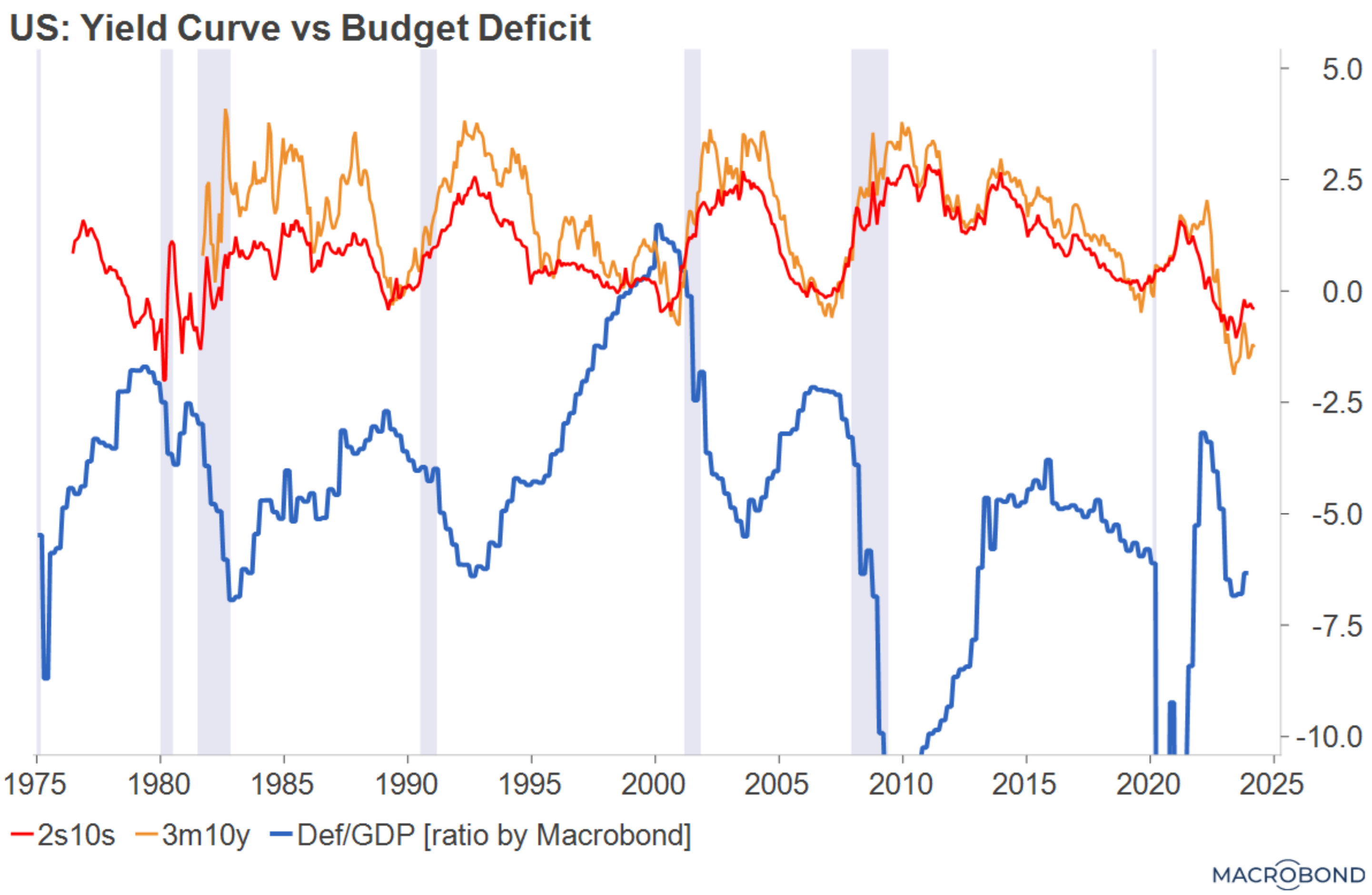
Why are Labour Markets STILL So Tight?
What Lessons Do They Hold?

Why Are Labour Markets Still Tight? US Easy to Explain

Demand side:
Monetary tightening has been offset by a higher near-term *r** (fiscal policy + post-crisis low rate, long duration borrowing)

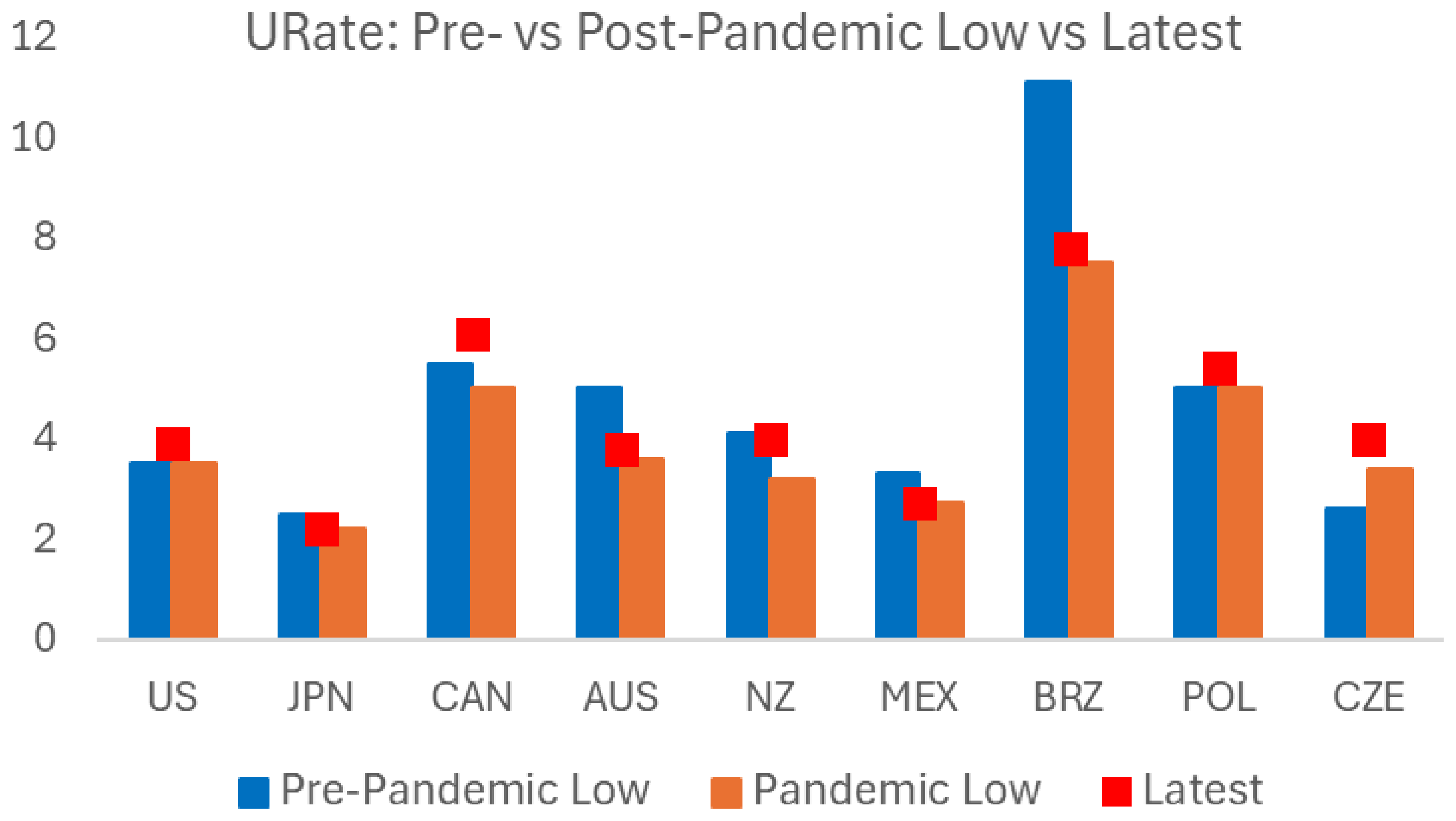
Supply side:
Higher immigration + LFPR *needs* substantial labour demand to be absorbed

External:
Goods (imported) vs services (domestic) inflation



Source: National sources, Haver Analytics, Talking Heads Macro

Why Are Labour Markets Still Tight *Globally*?

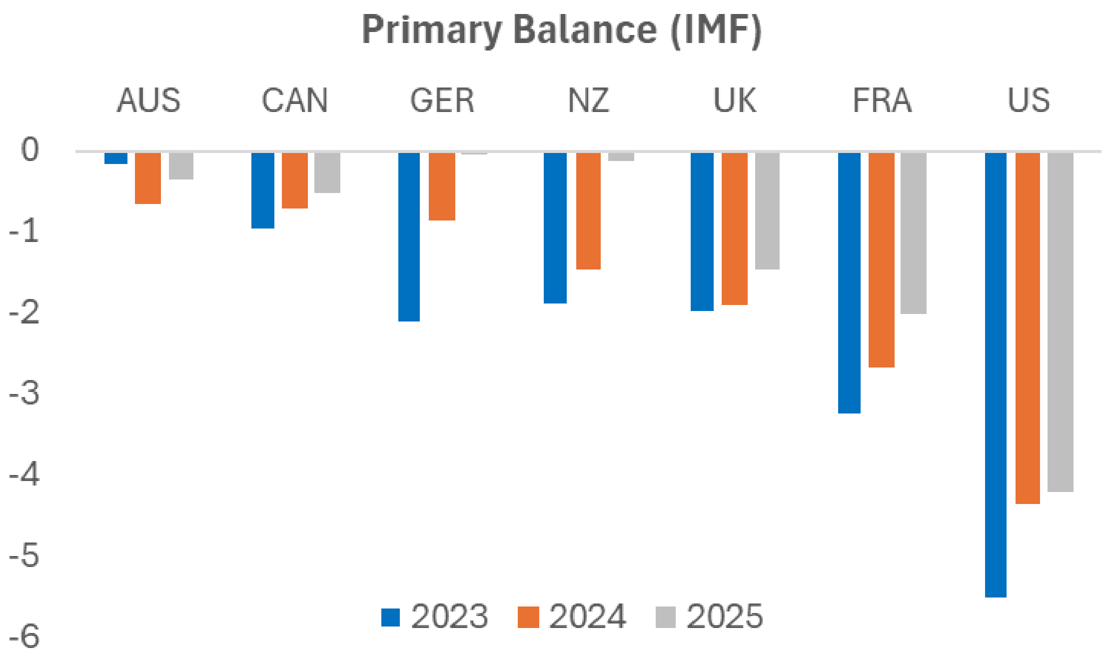


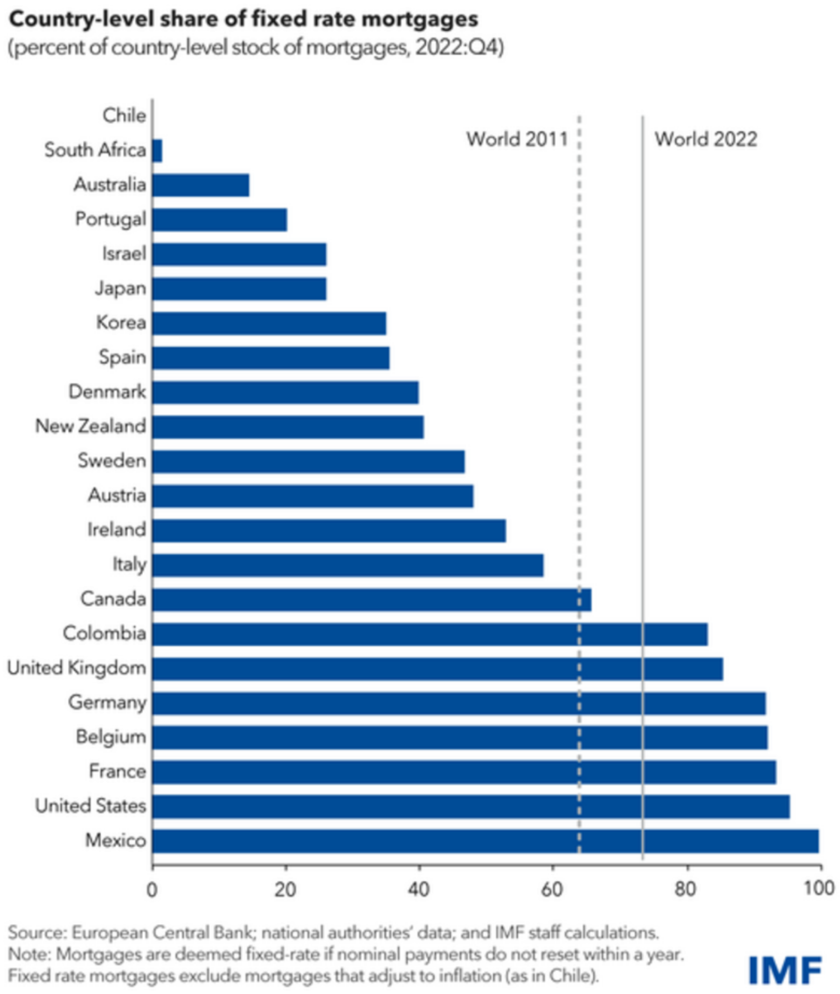
Source: National sources, Haver Analytics, Talking Heads Macro

Some Similarities, Major Differences

Similarities: Rate hikes, Immigration, Participation

Divergence: Fiscal, rate sensitivity, productivity



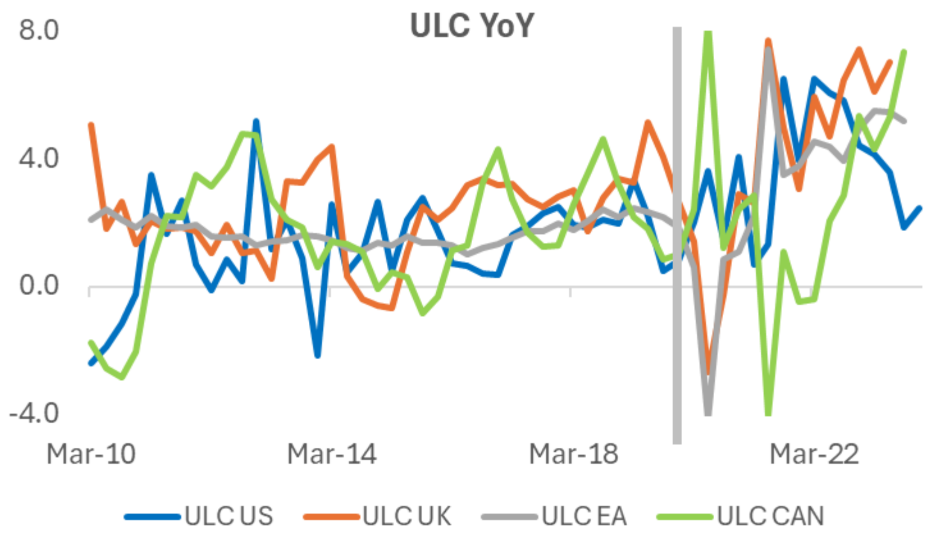


Source: National sources, Haver Analytics, Talking Heads Macro

What Could Explain Tight Labour Markets Globally?

On the supply side:

- Unit labour costs (i) benign in the US, (ii) offset by unit profits falling in economies that have slowed down.
- Labour hoarding + rational smoothing of employment by firms?

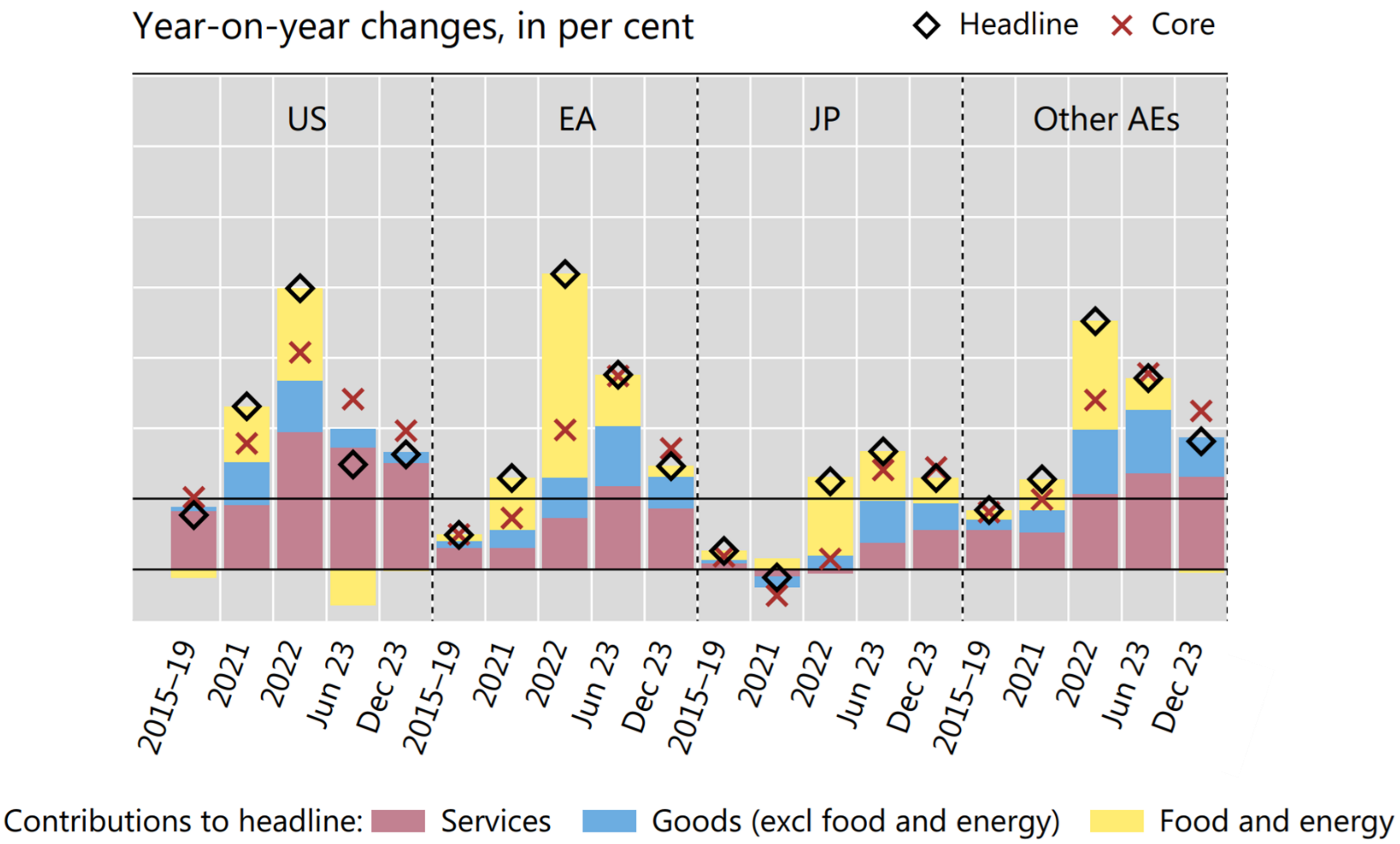


On the demand side: An unwillingness to hurt labour markets?

- The ease with which immigration + participation has been absorbed points to <u>excess demand</u>
- Excessive focus on a normalization of the Beveridge curve – looking backward to the pandemic
- A 'rescue line' from China?

Source: National sources, Haver Analytics, Talking Heads Macro

A China 'Lifeline' Again? For How Long?



Source: Amatyakul, Igan, Lombardi, BIS, April 2024, "Sectoral price dynamics in the last mile of post-Covid disinflation"

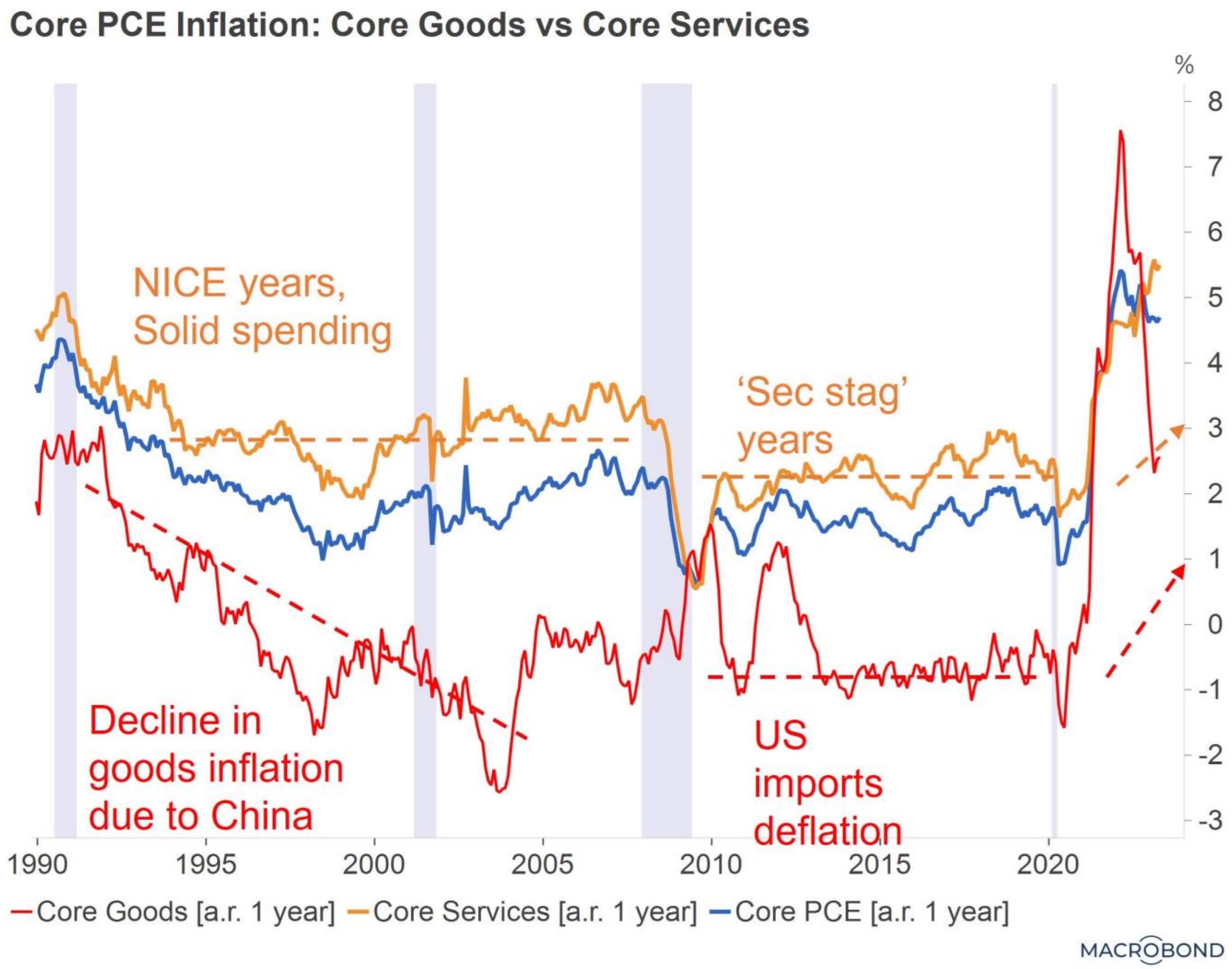
Two Phillips Curves

The Phillips curve for goods inflation is Made in China

- Outlook for deflation in China will determine goods inflation
- Pre-GFC: Rightward shift in AS
- Post-Covid: Leftward shift in AD

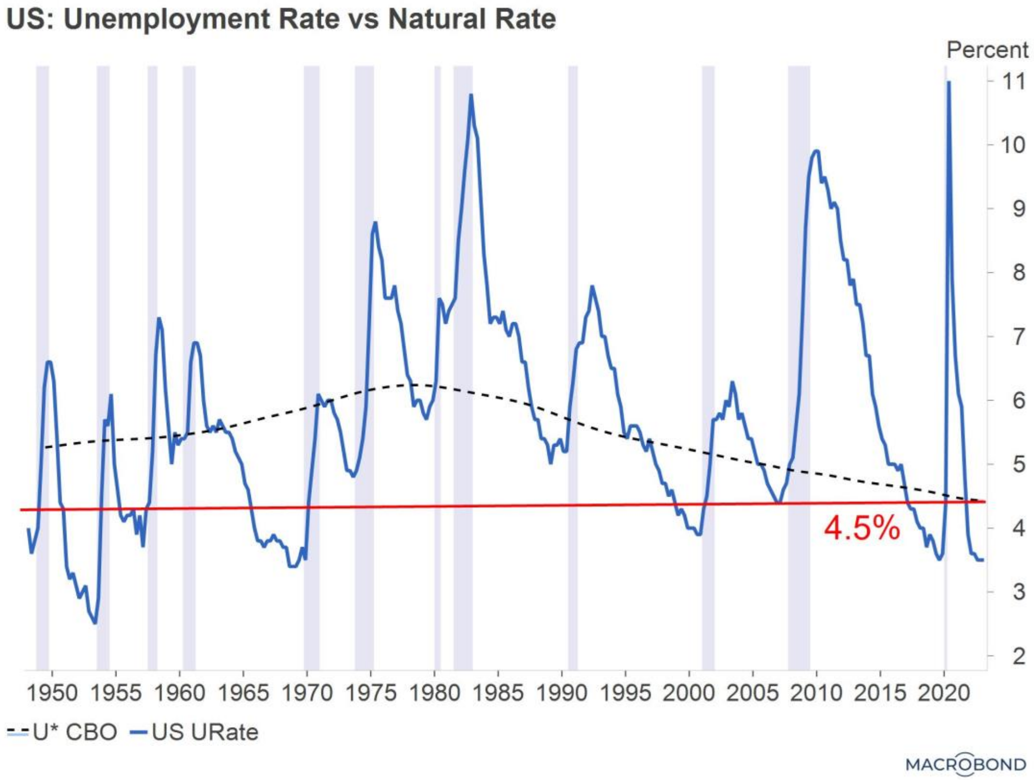
The Phillips curve for services inflation is driven by the US labour market

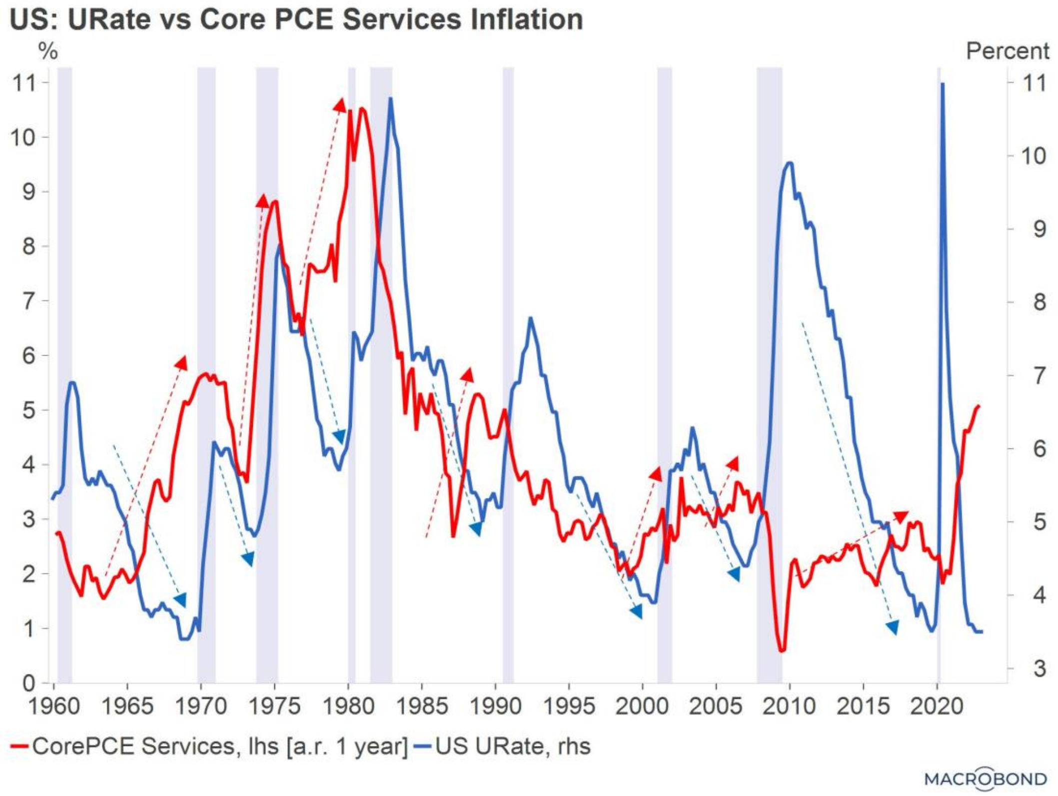
- Core PCE ex-housing is 56% of the core index and some 55-60% of that sub-index depends on wages.
- The exception is the financial sector.



Source: National sources, Haver Analytics, Talking Heads Macro

Levels Matter For Unemployment and Real Wages





Source: National sources, Haver Analytics, Talking Heads Macro

What Are Labour Markets Telling Us?

Labour markets will tighten much faster in future cycles. Loosening them will require greater economic slack in the future.

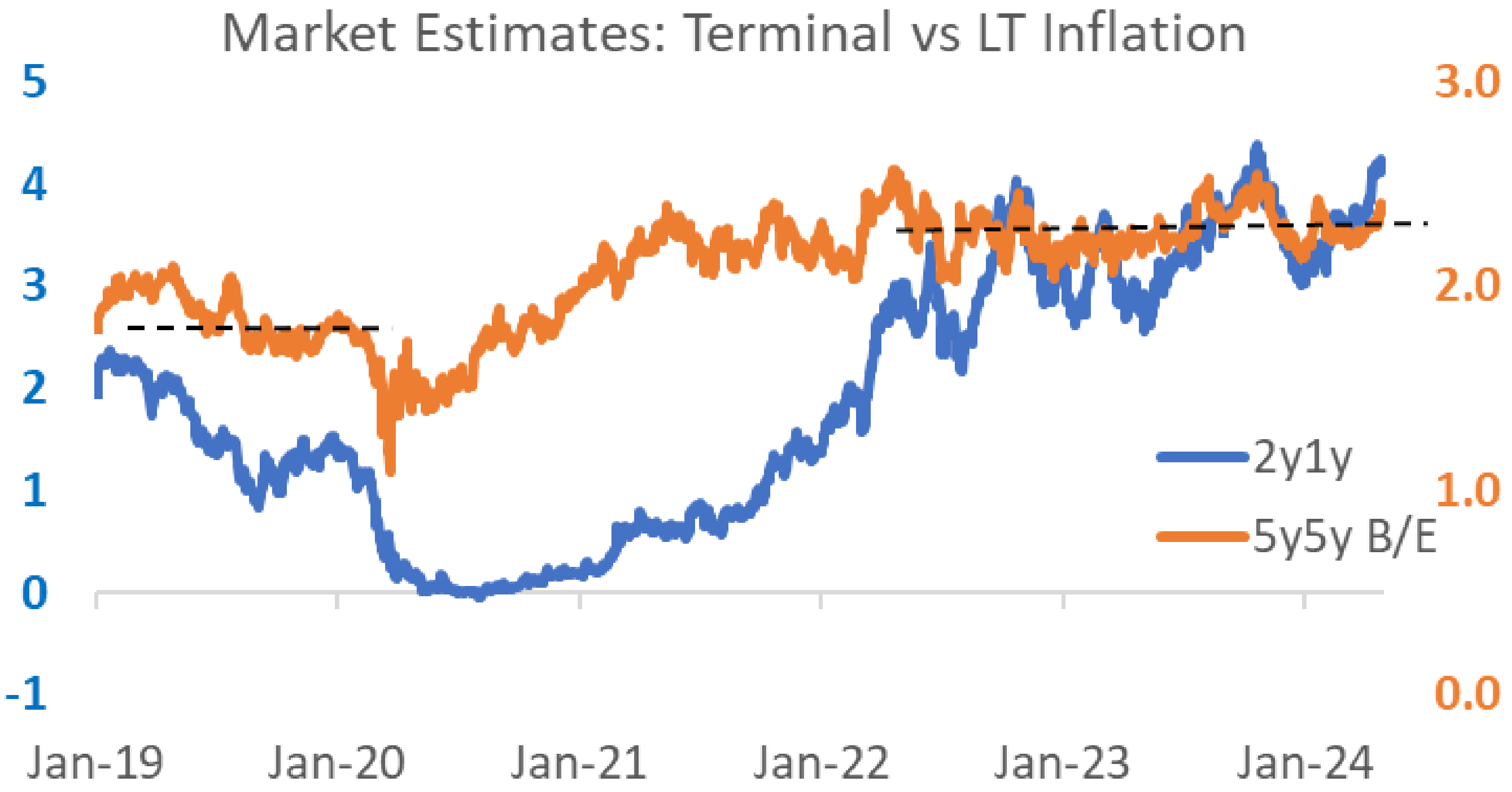
However, demography will drive a wedge between both components of the Debt/GDP ratio. There are thus financial stability limits to how much economic weakness markets will tolerate when it comes to **financing debt**.

Without the structural disinflation forces of demography/China, labour markets and **services inflation** are likely to dominate cycles.

In a slow-motion repeat of the Truss administration, central banks will have to increase their balance sheets to absorb some of the fiscal issuance, while using the short-term rate to affect domestic demand. The result? A sustained increase in both real interest rates and inflation.

Source: National sources, Haver Analytics, Talking Heads Macro

Inflation in the Next Cycle is More Dangerous

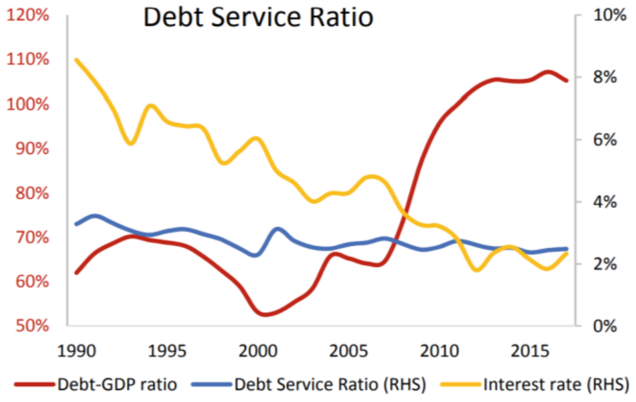


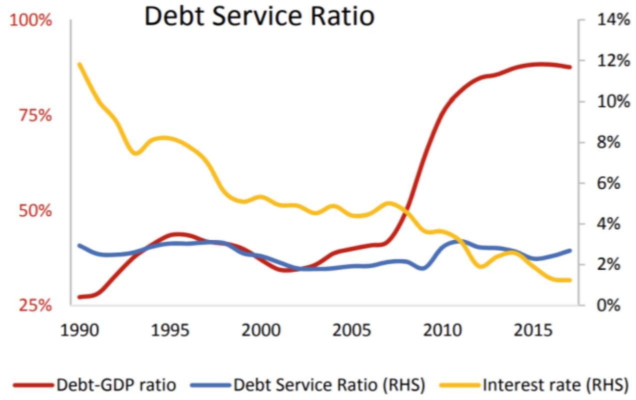
Source: National sources, Haver Analytics, Talking Heads Macro

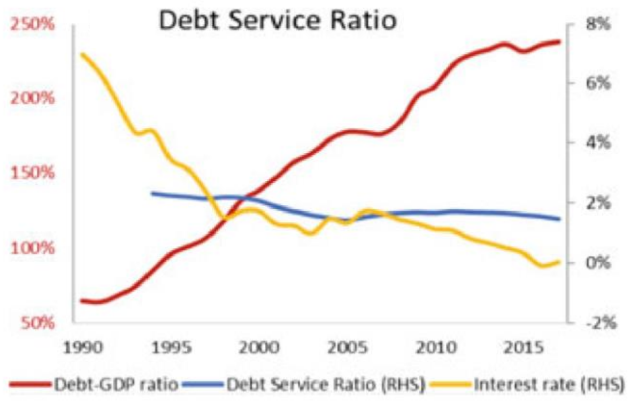
Appendix 1:
Why Didn't It Happen in Japan?

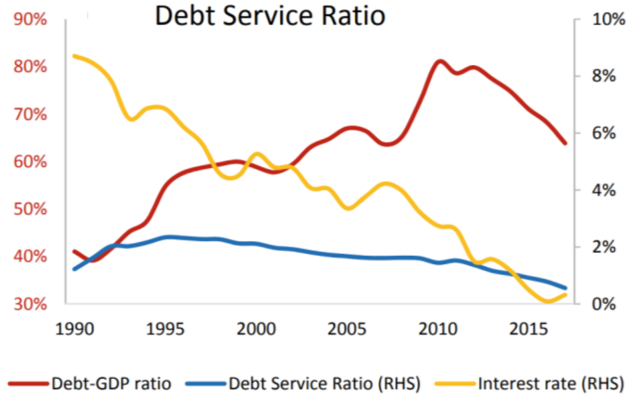
Why Didn't It Happen in Japan?

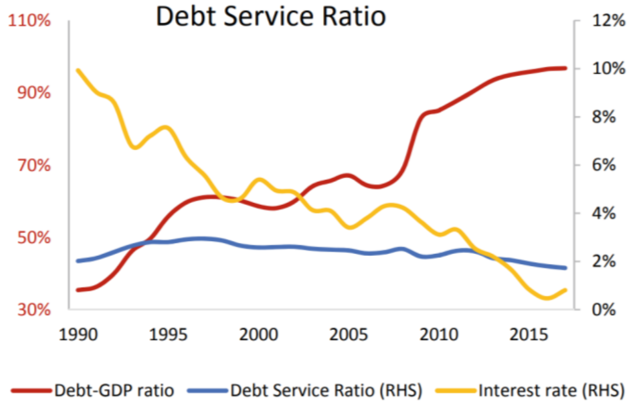
Japan was neither unique, nor resistant to global disinflation and the trend of falling interest rates

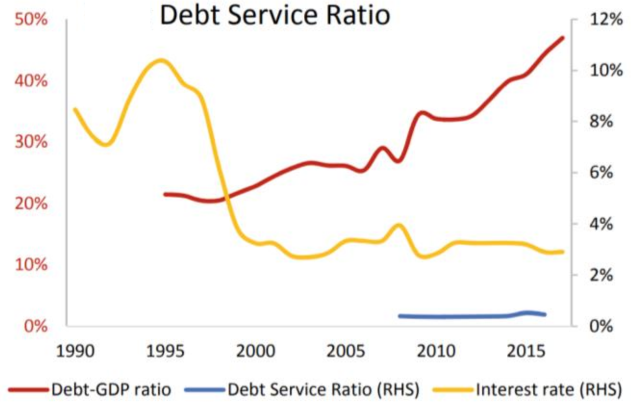










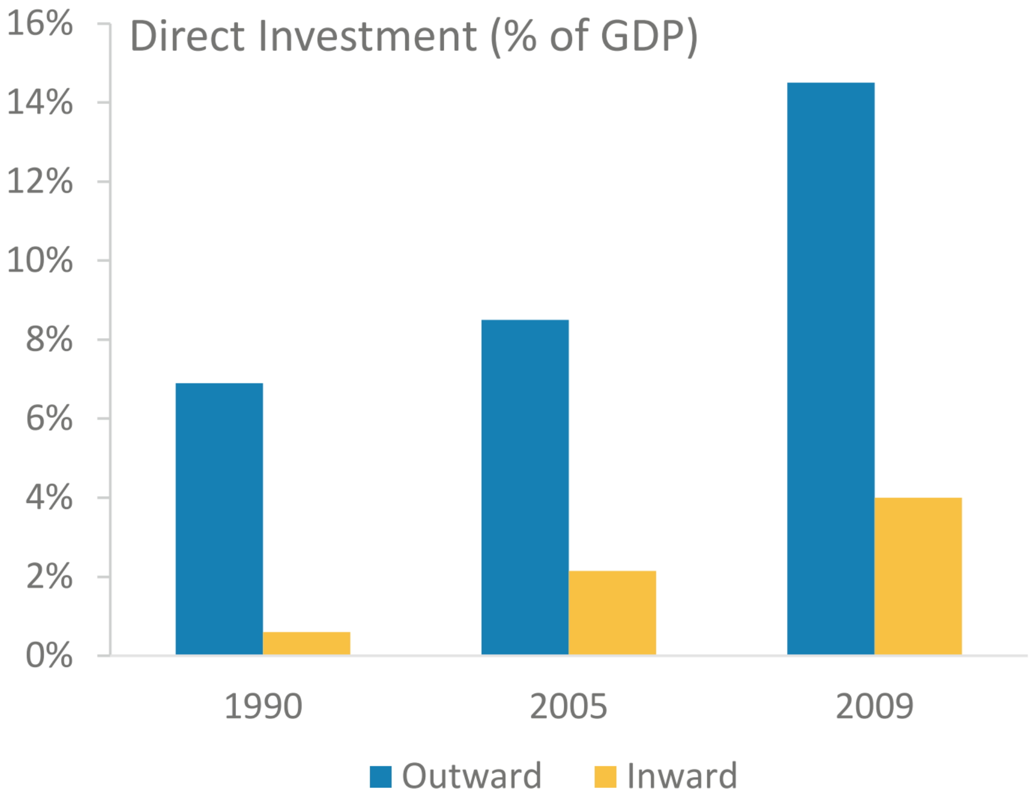


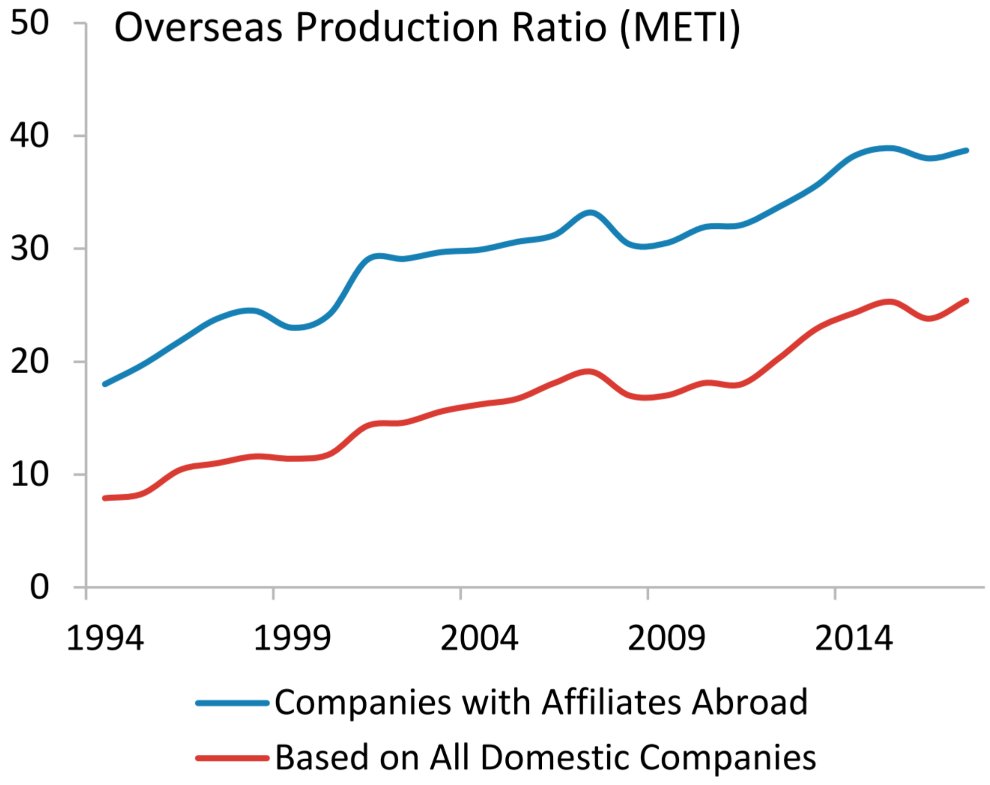
Source: Talking Heads Macro

Japan's Outbound FDI was an 'Escape Valve'

Without the global element, Japan demography forced to explain growth, inflation, rates

Corporates understood the global labour supply shock and used Outbound-FDI as a 'Escape Valve'





Source: Talking Heads Macro

Appendix 2:
Will China Remain Deflationary for longer?

Deflation Deepest When Imbalances Are First Reversed

Mainstream View:
China has long Covid + property downturn due to demography starting now

Our view:
Cyclically: production better protected than consumers
Structurally:
The demographic shock and the hard landing hit policy-makers in '12-'15

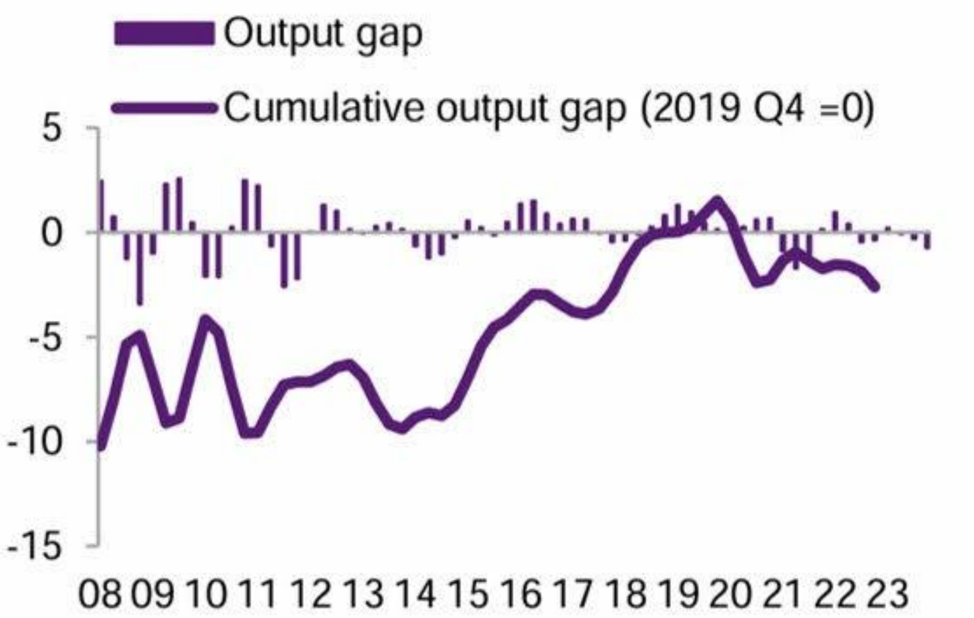
China's Deflation

	Post GFC	Post Pandemic
Starting Point	Hard vs Soft Decoupling	No desire to raise GDP growth
Policy	Massive credit surge in '09 Property bailout in '15	Massive fiscal surge in '20 Three Red Lines by the PBoC
Downturn/Deflation Triggers	Falling ICOR amidst property + capacity surge	(i) Property, (ii) Protecting production, not consumers
Excess Capacity	Property, steel, coal, chemicals, mfg, cement	Solar (hence US friction), cyclical hit from property
Policy Response	2015 bailout reduces to avoid debt deflation due to excess capacity	Incremental. Secondary housing, box office,travel flourishing
Global Spillover	Crisis in Russia and oil markets Brazil, Norway, Canada suffered India, Turkey, Argentina did not	Germany's auto industry

Source: National sources, Haver Analytics, Talking Heads Macro

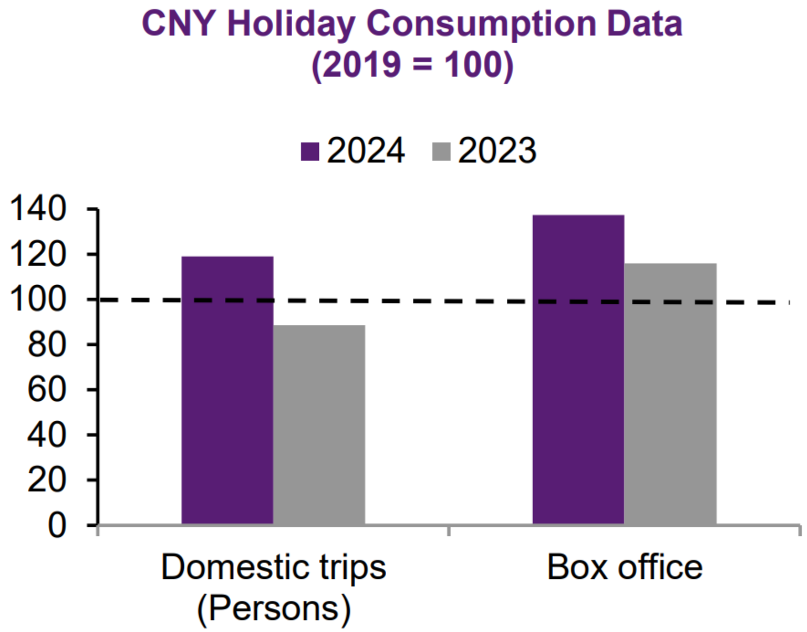
China Excess Capacity: Greater in '12-'15

China's Output Gap: Much Smaller Now



Source: Natixis, Author's calculation

China's Consumers are Showing Confidence

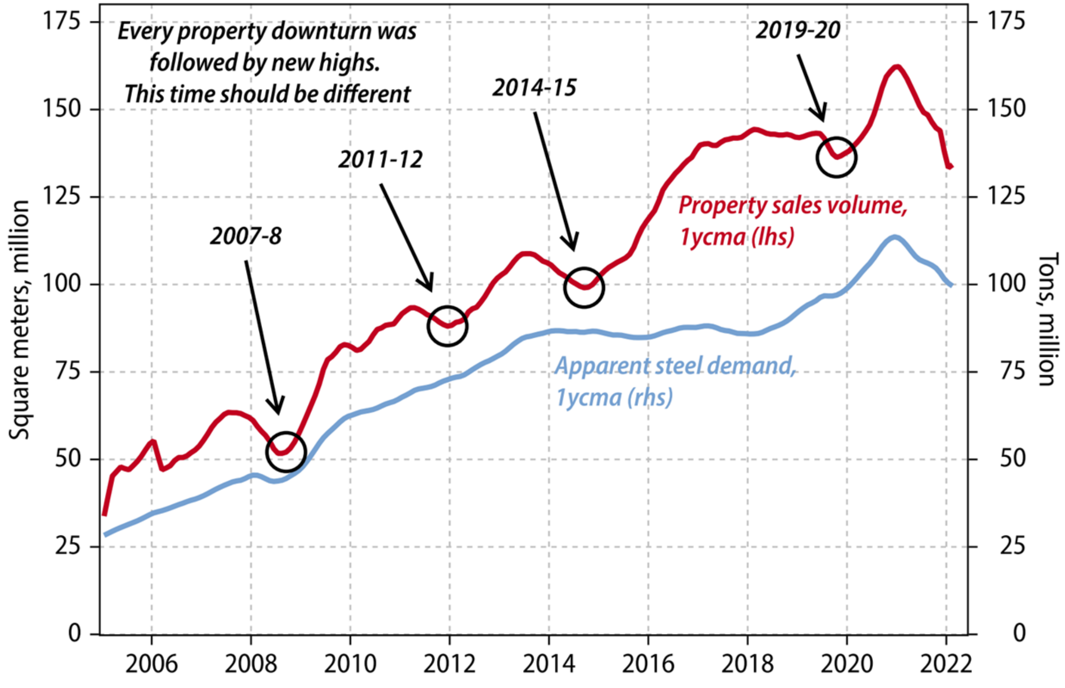


Source: Natixis, News

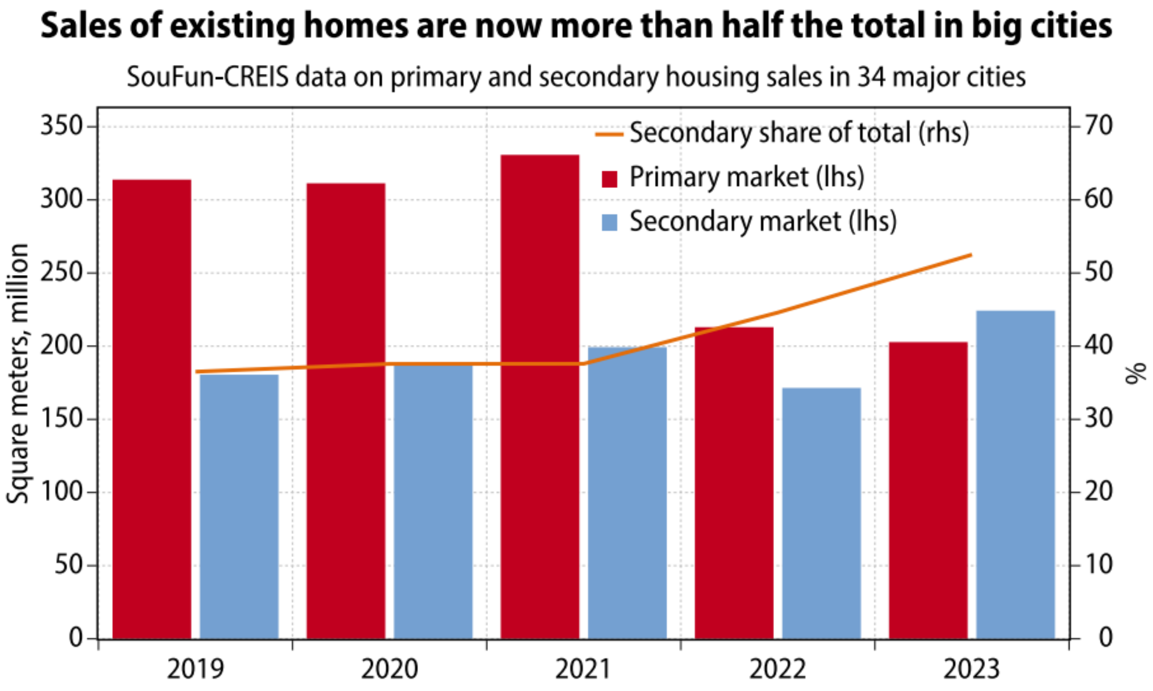
Source: Natixis, When Will China Recover From Its Cyclical Downturn?, 2024

China's Property Downturn: 2012-15 vs Now

China's Property Spillovers vs Mfg Excess Capacity



After the '3 Red Lines', Who Do You Trust?



Source: Gavekal, A Stoey of Two Housing Markets, 2024