

How big a threat is inflation?



Oliver's insights

Key points

- Inflation and talk of higher interest rates have replaced the credit crunch as the main worries for investors.
- Food & energy are the main drivers of higher inflation now, although it's broader in parts of Asia and Australia.
- Our assessment is that inflation will decline as growth slows and as oil prices fall in the next six months.
- However, inflation/stagflation worries over the next few months will add to the volatile ride for financial assets.

Introduction

Concerns about the global credit crunch and the US housing slump have been supplanted by worries about global inflation. This is evident in surging bond yields and tough anti-inflation talk from central banks. For investors rising inflation is bad news, particularly if it becomes entrenched. High inflation undermines real asset values, pushes up the yields investors require to invest, reduces the quality of company earnings, distorts economic decision making and ultimately leads to lower economic growth & rising unemployment. But how real is the threat?

Reasons for concern

While today's inflation rates are way below the double digit levels of the mid-1970s, there are reasons for concern.

Inflation is above target in most rich countries, it is up virtually everywhere & it is leading to a rise in inflation expectations which threatens second round effects.

Inflation is up virtually everywhere

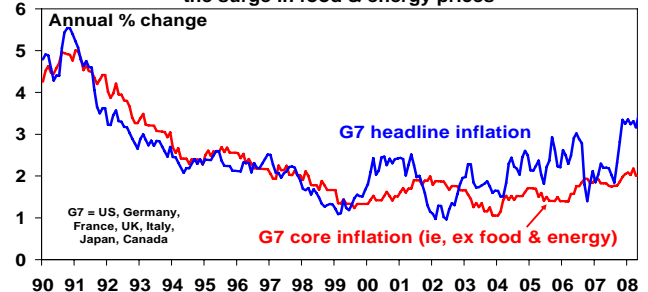
	Inflation rate, % year on year	
	Latest, %	Year ago, %
US	4.2	2.7
Japan	0.8	0.0
Euro zone	3.7	1.9
UK	3.0	2.8
Australia	4.2	2.4
China	7.7	3.4
India	7.8	6.7
Asia *	6.1	1.9
Latin America ^	6.8	4.6
Eastern Europe #	8.2	5.3

* Avg of HK, Indonesia, Malaysia, Singapore, S Korea, Taiwan, Thailand.
^ Avg of Argentina, Brazil, Chile, Mexico. # Avg of Czech Rep, Hungary, Poland, Russia. Source: Thomson Financial, AMP Capital Investors

Key drivers

Surging food and energy prices are the common factor behind rising inflation worldwide. Eg, in the G7 economies average headline inflation is above 3% but core inflation (ie, excluding food & energy) is still around 2%.

The rise in inflation in developed countries is mainly due to the surge in food & energy prices



Source: Thomson Financial, AMP Capital Investors

However, in Australia, the problem has been broader than just oil and food. Inflation excluding petrol and food was 3.2% over the year to the March quarter and the Reserve Bank's measure of underlying inflation was running at 4.3%. Nor can imported inflation be blamed – prices for items determined in globally rose 3.3% over the year to March whereas prices for items determined in the domestic economy rose by 5%. It would seem that the boost to national income from surging commodity prices has flowed through to domestic spending which has allowed price increases to flow through in a broader range of areas.

Asia has also seen a more broad based pick-up inflation. Higher food prices have had a greater impact because they typically have a 30% weight in Asian consumer price indices (versus 15% in rich countries). More fundamentally though the combination of strong demand, waning excess capacity from the late 1990s Asian crisis and undervalued exchange rates have seen underlying inflation rise as well in several Asian countries, although not so far in China.

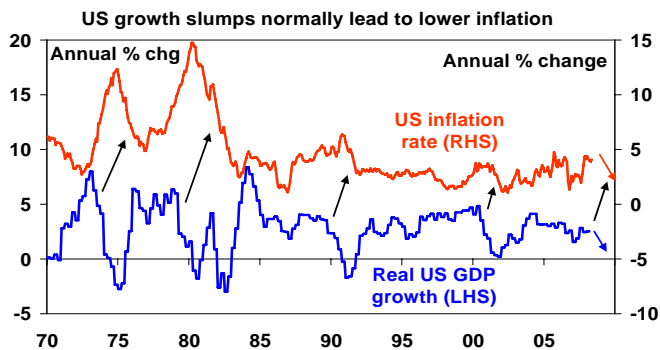
Reasons to expect inflation to fall over the year ahead

Inflation is likely to remain high over the next few months. This and attendant stagflation talk is likely to provide an ongoing source of jitters for share markets in the very short term. However, it's hard to see it going too much further.

- The first thing to note is that, **despite the surge in food and energy prices which also occurred in the 1970s there are big differences between now and then which should prevent high inflation becoming entrenched.** We haven't seen the huge productivity zapping expansion in government that occurred into the 1970s. The global economy is now far more competitive following the end of the Cold War. Labour markets are generally deregulated, union membership is down sharply and centralised wage setting in Australia is a thing of the past. Independent central banks have taken

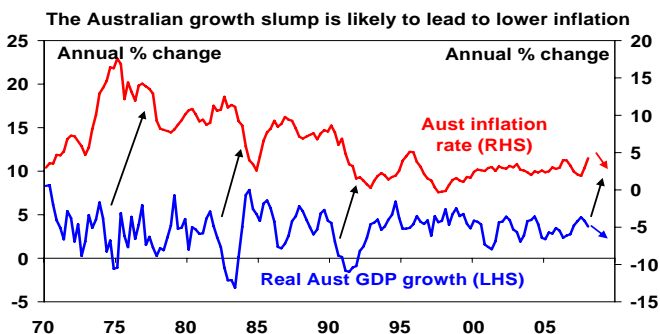
monetary policy away from politicians and inflation targeting helps anchor long term inflation expectations. And financial market deregulation now means the consequences of allowing high inflation become quickly apparent in higher interest rates or a falling currency.

- Secondly, the downturn in global growth now underway will likely lead to lower inflation over the next year as excess capacity is freed up. Every major economic downturn in recent times has led to lower inflation. This is illustrated for the US in the next chart.



Source: Thomson Financial, AMP Capital Investors

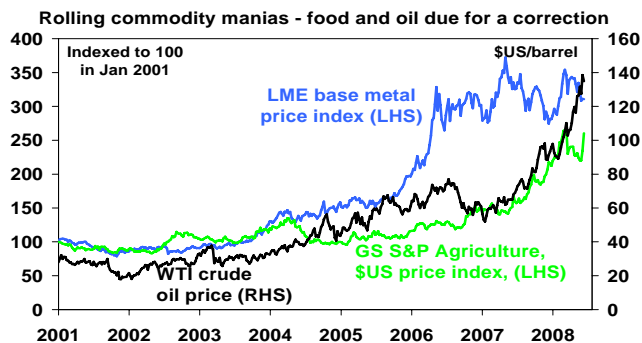
This will also be the case in Australia, where a sharp slowdown in a whole array of economic indicators – housing finance, housing starts, consumer and business confidence, retail sales, car sales, employment, etc – indicate that the RBA is now getting the downturn that it has sought. If history is any guide this will lead to lower inflation.



Source: Thomson Financial, AMP Capital Investors

- Thirdly, one of the reasons inflation became so entrenched in the 1970s was that higher fuel and food costs fed into wages growth, creating a wage price spiral. Today there is no evidence of this. **Wage growth in most countries has remained pretty benign.** With economic growth slowing it's hard to see wages growth picking up. **This is certainly the case in Australia where the softening labour market means that the risk of a wages breakout is rapidly receding.**
- Fourthly, we are likely to see some short term relief in food and energy prices. The past few years have seen rolling manias in various commodity prices give way to a period of range trading. This was first evident in base metal prices which have now been range trading for two years. Agricultural commodity prices after going exponential into early this year now seem to have entered a range trading period. While oil is still in the blow-off phase it's likely that it too will soon enter a range trading environment as slowing global growth cuts into oil demand leading to an unwinding of

speculative positions. **We see the oil price falling back to about \$US100 a barrel sometime in the next six months and this will cut headline inflation rates substantially.**



Source: Thomson Financial, AMP Capital Investors

- Finally, the global rise in bond yields on the back of inflation worries has come at a very bad time. Higher bond yields are boosting fixed rate borrowing costs (US mortgage rates are little different from when the Fed started easing last year!) which will make it even harder for housing markets and the flattening US yield curve (as short term interest rate have risen faster than long term rates) will put more pressure on struggling US banks because they borrow short and lend long. This will all add to the downward pressure on global growth which in turn will flow through to lower inflation.

So for all these reasons we see inflation falling over the year ahead – both globally and in Australia. As a result it's unlikely that central bankers will raise interest rates to the extent now priced into financial markets, if at all. The ECB may be the exception, but it's hard to see a tightening any time soon in the US. The Fed has rarely tightened when unemployment is rising. **And we remain of the view that the RBA has done enough to ensure that inflation will head back to target on a reasonable time frame.** If anything it has probably done too much. The slump in demand indicators suggests that the economy has reached a tipping point and that the negative forces of higher interest rates and high petrol prices are overwhelming the positive impact of high commodity prices and tax cuts. The risk of a hard landing is now significant. Talk of another RBA rate hike is crazy and the next move will be a rate cut.

This would all suggest that bonds on current elevated yields are providing good buying opportunities. And signs of lower inflation, lower oil prices and lower bond yields should underpin a rally in shares from later this year.

Concluding comments

There are a number of longer term issues regarding inflation, including whether Asia is becoming a source of global inflation and the implications if Asian countries allow their currencies to strengthen to combat inflation, which will be a topic for another day. However, our key conclusions are that the next few months are likely to remain challenging for share markets as inflation and interest rate worries add to concerns about weak growth but that later this year we see inflation concerns abating in lagged response to slower growth and also as oil prices fall back. This should be positive for shares into year end.

Dr Shane Oliver
Head of Investment Strategy and Chief Economist
AMP Capital Investors

Important note: While every care has been taken in the preparation of this document, AMP Capital Investors Limited (ABN 59 001 777 591) (AFSL 232497) makes no representation or warranty as to the accuracy or completeness of any statement in it including, without limitation, any forecasts. Past performance is not a reliable indicator of future performance. This document has been prepared for the purpose of providing general information, without taking account of any particular investor's objectives, financial situation or needs. An investor should, before making any investment decisions, consider the appropriateness of the information in this document, and seek professional advice, having regard to the investor's objectives, financial situation and needs. This document is solely for the use of the party to whom it is provided.