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Inflation: Too little today, too much tomorrow?

- Inflation to stay low in the short and medium term as excess capacity remains in developed economies
- Current QE programmes to have a moderate inflation effect, potentially forcing policy-makers to engineer further monetary loosening
- We prefer higher yielding assets in this environment as capital values are likely to remain volatile as a fragile economic recovery ensues

Global Perspective



Inflation: Too little today, too much tomorrow?

As inflation is too low in a number of western economies, policymakers are reacting by embarking on a new round of quantitative easing. Powerful disinflationary forces suggest that if inflation goals are to be met, then much more significant monetary loosening would be needed.

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Introduction

Inflation in the developed economies has been structurally subdued for over two decades. Following the Great Recession and financial crisis of recent years, inflation now may be too low for the western world's monetary authorities, especially in the US. Here, the Federal Reserve (Fed) has restarted its Quantitative Easing (QE2) programme by committing to buy medium-dated Treasury bonds to boost economic activity and inflation expectations longer term. To understand why there are inflation concerns in western economies, we analyse what drives inflation. We suggest it may stay too low in the short term in the major OECD economies, but is also unlikely to run away in the longer run unless a more dramatic change in policy occurs. To help illustrate our prognosis, we have developed a simple model which forecasts the outlook for inflation in both a central and an upside case for the US economy.

Disinflation today

Many investors are concerned that inflation levels are too low. This reflects slack in key parts of western economies, notably the housing and employment markets, while economic growth in many countries is uncomfortably weak for this stage of the business cycle – see Chart 1 for the US. This has prompted unprecedented action to loosen monetary policy in recent years across the western world. The recent Fed response through QE2 is actively being considered by others, such as the Bank of England and the Bank of Japan. Such QE policies are designed, via the purchase of medium-dated government bonds, to boost growth and jobs in the economy through positive wealth effects in asset markets and to keep market interest rates low for borrowers. The danger the authorities worry about is a change in corporate and consumer behaviour that means a delay to consumption resulting in a downward spiral in prices – i.e. entrenched deflation, as prices are cut to stimulate spending. With consumption accounting for about 70% of US GDP, and similarly dominant in most developed economies, the importance attached to whether QE policies work could not be higher.

Despite the immediacy and size of the response by the monetary authorities in tackling the sluggish growth problems in the US, we argue that the chances of a boost to inflation appear limited in the shorter term for a number of reasons.

Interest rates cannot fall below zero and hence on Taylor-type rules appear too high for the level of economic activity and inflation in the economy. The loosening of monetary policy via QE2 pushes more liquidity into the system, creating a higher monetary base,

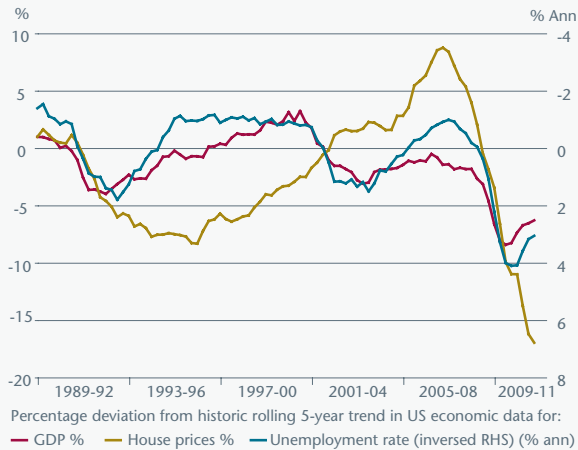
which, in theory, is the equivalent of lower interest rates. However, much of this liquidity also leaks from developed economies so any boost to economic capacity is also very circumspect. Additionally, a liquidity boost may not be inflationary as the velocity of circulation of money remains subdued, lessening the impact of such money printing. Japan is a salutary lesson in what can go wrong if QE is applied too late and in insufficient size. Accordingly, money velocity slowed sharply due to changed behaviour from consumers and businesses who saved rather than spent any money given to them – the so-called liquidity trap.

Further concerns relate to future demand for credit as banks and consumers continue to reduce their levels of leverage. Regulatory reform via Basel III also means higher capital levels for banks and hence less ability to create new credit. US mortgage demand has already decelerated in recent years for any given level of interest rates. In the UK, recent mortgage lending data has been a small fraction of that being lent just three or four years ago. This is evidence that mortgage holders are becoming less sensitive to the level of mortgage rates. All in all, it may be doubtful that further QE will materially help the housing or borrowing markets while consumers worry about negative housing equity or the state of the jobs market.

Fiscal and currency headwinds are also important to consider. One of the less helpful consequences of further monetary loosening via a falling US dollar has been the recent 10% rise in the oil price. If sustained, this would, de facto, be a 'tax' on growth in the longer term. Of course, the flipside of a weaker US dollar is stronger profits growth for certain US companies, although this has a limited economy-wide impact. Stronger currencies elsewhere, for example, the yen and the euro as the result of the declining dollar, are another global growth headwind. Additionally, fiscal retrenchment, especially in Europe, may also knock 0.5% to 1% off GDP each year, again keeping output gaps wide. Persistently large output gaps, when they have occurred through history, have meant little subsequent upside risk for inflation, due to stubbornly high unemployment and moderating nominal wage growth.

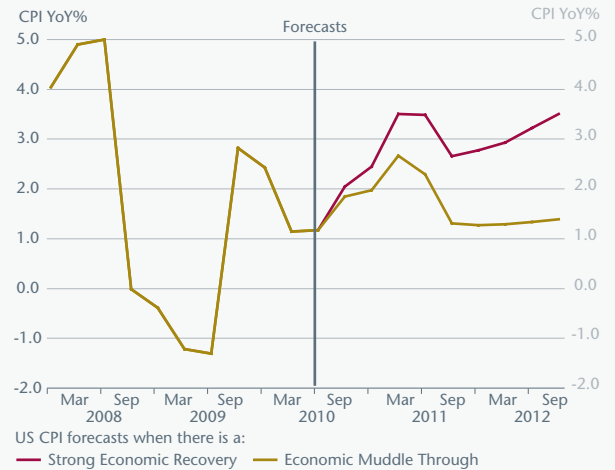
Therefore, in summary, in the short run disinflationary forces in western economies, especially the US, appear too powerful to be overwhelmed by the recent loosening of monetary policy. Additionally, the chance of any further fiscal loosening appears constrained by the ballooning of national budget deficits. This suggests the policy response in the short term is unlikely to cause inflation.

Chart 1
Slack in the system = low inflation



Source: Standard Life Investments, Bloomberg

Chart 2
Inflation under two economic scenarios



Source: Standard Life Investments, Bloomberg

Inflation tomorrow

While excess slack in western economies may be high, measuring it is fraught with difficulties. One issue to contend with is the permanent loss of output in an economy after a recession. Two sectors spring to mind – housing and finance. If capacity is lost for ever, the upward inflationary impact of loose monetary policy and QE may be understated. Certainly, monetary loosening via the boosting of an economy’s money supply may be effective in the longer term. There appears to be some evidence, as described by the ECB, that over a cycle a higher monetary base equals higher inflation. So, if QE continues for long enough, there may be an inflation surprise to the upside going forward.

Liquidity injection into the economy via QE may also be successful if inflation expectations rise. For example, while long-established surveys of consumer sentiment remain contained, a recent UK survey of financial markets participants found only 10% of respondents thought the Bank of England’s grip on inflation was secure. Some 32% suggested that it was not secure, while the balance of participants anticipated some slippage in the absence of wage restraint. However, wage inflation in the UK (around 2% p.a.) and in other western economies appears well contained, suggesting little pricing power from the labour market and hence further containment for inflation. However, further incremental gains to employers may be limited when it comes to cutting wage rises as they get harder to cut the closer they get to zero. One strategy to maintain corporate operational leverage, and hence profits, in the absence of this cost control mechanism is to raise selling prices and accept any lower volumes that may result. This could directly feed through to higher measured inflation.

The other inflation danger ahead is if QE2 is deemed ineffectual because the monetary transmission mechanism remains broken and positive wealth effects accruing to consumers are saved rather than spent. In this scenario, the authorities might embark on even more aggressive policies and, say, start to target inflation rates. This could be via putting money directly in people’s pockets, e.g. tax cuts financed by central banks, rather than purchasing government bonds in order to engineer higher inflation. This might rely on a further major policy response sometime after the targeted end of QE2 in mid-2011, in the case of the US.

Inflation forecast

Given the arguments above, where is inflation likely to go in the next few years? We have developed a simple model of US inflation which is driven by the lagged effects of average wage growth, commodity prices and durable goods inventory (an indicator of the lack of spare capacity in the economy and our growth proxy). Using the results of this model, formulated over the last 25 years and testing various economic scenarios in the US economy, gives the results shown in Chart 2 for the two years ahead. Here, the central case for the economy assumes a modest rise in wages, commodity prices and inventory growth, which leaves inflation in the 1-2% range. In the strong economic recovery scenario, we assume a much weaker US dollar causes commodity prices to rise 5% a quarter in 2011 and 7.5% a quarter in 2012, with wage inflation rising from 2% p.a. to more than 6% p.a. over the same period. Durable goods inventories are assumed to rise strongly. In this scenario, inflation moves up quickly in 2011 from 1% currently to around 3%, where it stays through 2012.

This would be an ideal inflation outcome for the US authorities, if the upside risk for commodity prices, wages and inventories coincides with a strong economic and jobs recovery. In our central case, we think this is an unlikely outcome and warn that the danger for the immediate years ahead is that powerful disinflation forces are more likely to dominate the economic landscape in the western economies. As we showed in a Global Perspective article in May 2010, it is a permanent change in inflation expectations that leads to a strong asset price reaction. To change inflation expectations permanently, we believe that a larger monetary response would be needed from the US and western authorities than that already announced. In summary, if central bankers decide that higher inflation must be engineered, then investors should anticipate another phase of extraordinary policy measures through QE3.

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House View

SLI recommended asset allocation for Canadian balanced mandates.

	Positive	Negative	Our View
Canadian Equities	<ul style="list-style-type: none"> Earnings will respond to lower loan losses and generally high commodity prices as the economy expands. Canada remains a geared play on global growth. 	<ul style="list-style-type: none"> The market rallied hard in 2009 on the bottoming in the global economy. Key issue is whether commodity prices will be maintained or continue to rise, thus supporting the level of earnings now being discounted in the market. 	<p>The portfolio continues to feature high-quality companies. We increased our focus on higher conviction buys and trimmed lower conviction views. We are positive on banks, oils and select commodity producers. OVERWEIGHT.</p>
US Equities	<ul style="list-style-type: none"> The US market will benefit from a global improvement in earnings and good operating leverage. We also like the more diversified sector allocation, with better exposure to areas such as health care and technology for Canadian investors. 	<ul style="list-style-type: none"> The market is pricing in strong earnings growth in 2010. Lower financial loan loss provisions and positive operating leverage offers the prospect of better earnings in an otherwise muted economic environment. 	<p>We have increased our OVERWEIGHT position in US equities reflecting valuations, the appeal of the dollar vs. the loonie and the relatively steady growth nature of the market. With firmer growth prospects in the US than in Europe and Japan, we think the US dollar can be in a longer-term rising phase.</p>
EAFE Equities	<ul style="list-style-type: none"> EAFE tends to outperform in cyclical rallies, as earnings are more geared to the cycle and valuation tends to improve as well. Valuation in the UK and Europe remains at a discount to other global markets, especially compared to Emerging Markets and the Pacific region. 	<ul style="list-style-type: none"> Challenges remain. The Japanese recovery remains fragile and dependent on exports. Europe is also highly dependent on trade to stimulate growth and faces tighter fiscal policy due to huge budget deficits; European banks have been slower to recognize losses and have higher government involvement. EAFE recovery requires the Euro and Yen to weaken further. 	<p>With a still strong rebound in global activity, we lifted our position in funds in the autumn but remain UNDERWEIGHT. The fiscal situation in Europe, especially Portugal, Italy, Greece and Spain will be a drag on growth even assuming a bail out is organized for Greece.</p>
Real Estate	<ul style="list-style-type: none"> Capitalization rates have risen. Real estate typically produces positive returns even in a difficult period. Vacancy rates are low in Canada. 	<ul style="list-style-type: none"> Market turnover remains very low, and it requires perseverance to find opportunities at attractive valuations. 	<p>This asset class benefits from cash flow and stability over the cycle. NEUTRAL</p>
Canadian Bonds	<ul style="list-style-type: none"> Inflation is low in Canada and the economy is recovering more slowly than the US due to the high loonie. Long-dated corporate and provincial bonds remain attractive. Rates will have to stay low in Canada just to lean against the currency. 	<ul style="list-style-type: none"> Long-term yields at 3% are not attractive on a multi-year view, especially compared to equities. Corporate spreads in the short- and mid-term parts of the market are back to their long-term lows, and offer less-compelling value. 	<p>With the sharp fall in long-term yields, we have now cut our bond positions to UNDERWEIGHT. Within the portfolio, we hold longer-dated corporate and provincial bonds, and benefit from still very wide spreads. With economic momentum likely to peak by mid-2010, long-term credit has solid risk-adjusted return potential.</p>
Cash	<ul style="list-style-type: none"> We can use cash if conditions warrant for acquisitions or short-term defensive reasons. 	<ul style="list-style-type: none"> Not attractive as a long-term asset given the low yields. 	<p>We hold minimal cash levels, given their low yields and favourable outlook in bonds. However, we have added to cash holding for reinvestment as opportunities arise. UNDERWEIGHT</p>

The terms Overweight, Neutral and Underweight express Standard Life Investments' view of a balanced portfolio against a given benchmark.