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Deflation or rising inflation – what is the risk?

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Key points

> Low/falling inflation suggests that right now deflation is maybe more of a risk than rising inflation in developed countries. Falling inflation reflects significant spare capacity globally and soft commodity prices.

> Inflation is likely to stop falling next year as global growth picks up, but a significant rise in inflation looks a way off.

> This means low interest rates will be with us for quite a while which is a positive for growth assets.

Introduction

Ever since the global economy started to "recover" from the global financial crisis in 2009 a constant concern has been that all the money printing by central banks in the US, Europe and Japan will result in sharply higher inflation in developed countries. This has not happened. In fact over the last couple of years inflation has been falling with the US, Europe, Japan and Canada all having inflation rates of 1% or less. Australia has relatively high inflation but it's only 2.2%.

Oddly enough, at present inflation is really only an issue in some emerging countries – notably Brazil, Indonesia and India – where it reflects a combination of slowing productivity growth and cost pressures. But that's a separate issue.

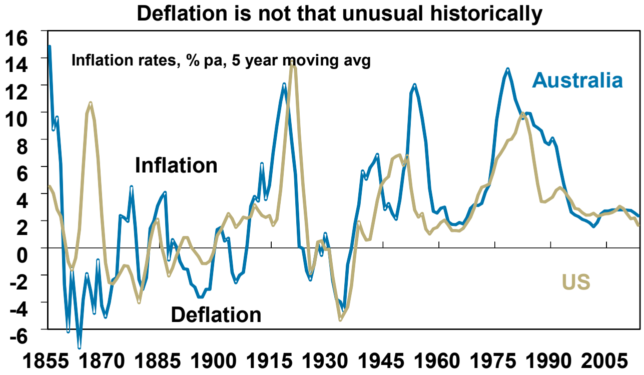
The plunge in the price of gold from a peak of $US1900/ounce in 2011 when hyperinflation fears were at their peak to around $US1240 now is another sign that inflation pressures are weak.

Why those predicting hyperinflation over the last few years have been wrong is very simple. Put simply they did not understand the link between quantitative easing and inflation. While central banks have boosted narrow measures of money – bank reserves and cash in the system – this needs to be lent out en masse boosting broad measures of money supply growth and credit, resulting in much stronger levels of economic activity and the elimination of excess capacity before inflation takes off. And of course this hasn't really happened so no hyperinflation. Too bad for the gold bugs!

The absence of inflationary pressures is in fact a good thing, because it means the global "sweet spot" of gradually improving economic growth, with low interest rates and bond yields can continue for some time to come. But what if inflation continues to fall and we end up with deflation?

Deflation - what is it?

Deflation refers to persistent and generalised falls in prices. In other words, the consumer price index would fall rather than rise as we have become used to. A long run of history shows deflation is not that unusual. Deflation occurred in the 1800s, the 1930s and over the last 15 years or so in Japan.



Source: Global Financial Data, AMP Capital

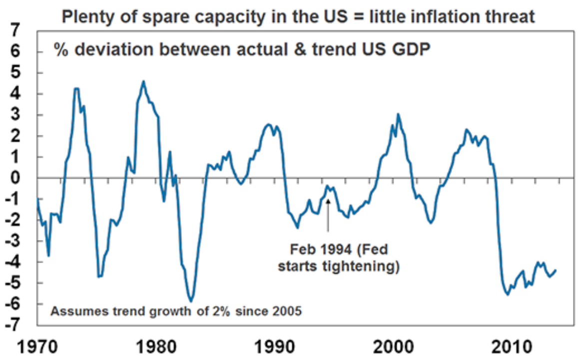
However, deflation can be good or bad depending on the circumstances. In the period 1870 to 1895 in the US, deflation occurred against a background of strong economic growth, reflecting rising productivity growth and rapid technological innovation. That was "good deflation". Lower prices are good for consumers because they boost real purchasing power, but not if they are associated with falling wages, high unemployment and falling asset prices. For example, in the 1930s and more recently in Japan, deflation reflected economic collapse. That is "bad deflation".

Why would deflation be a threat?

In the current environment, a slide into deflation would likely be bad. Falling wages and prices would make it harder to service debts. Lower nominal growth will mean less growth in public sector tax revenues making still high public debt levels harder to pay off. And when prices fall people put off decisions to spend and invest, which could potentially threaten a relapse into recession. And of course this would be made worse if return to recession results in falling asset prices as there would be the risk that a "debt deflation" spiral takes hold, as Japan has seen over the last 15-20 years.

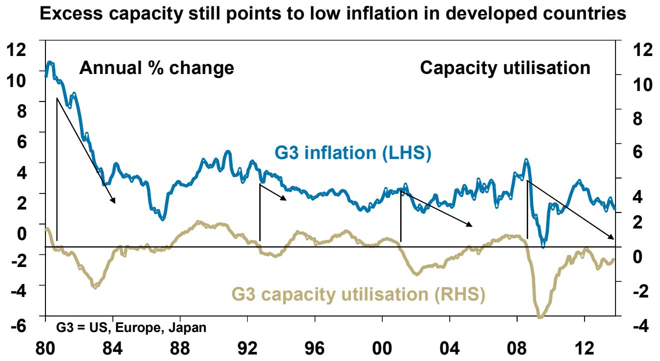
But how serious is the risk of deflation?

The short answer is that the risk of deflation is low but it is not insignificant. A combination of factors explains the fall in inflation. First, global spare capacity remains significant, reflecting the fact that economic growth has been poor. Real economic activity is running well below potential which has resulted in significant output gaps, as can been seen in the next chart for the US.



Source: Bloomberg, AMP Capital

The next chart shows that inflation in the G3 (US, Europe and Japan) tends to fall when capacity utilisation averages below zero. And this remains the case at present.



Source: Thomson Reuters, AMP Capital

It is also evident in still high unemployment rates of 7.3% in the US and 12.2% in the Eurozone all of which is resulting in very weak growth in labour costs.

Second, and related to this, as already noted growth in broad money measures and bank lending has remained subdued as banks have been more cautious in lending and borrowers have been more focussed on paying down debt.

Finally, commodity prices have been in a downtrend as emerging country growth has slowed (with China growing 7-8% rather than 10% plus) at a time when the supply of commodities has improved after a surge in investment. Think of the massive boost to mining output capacity and the surge in oil and gas production in the US as a result of shale fracking. This is very different to last decade when Chinese demand soared at a time when commodity supply was constrained after years of underinvestment.

So all of this has come together resulting in falling inflation.

What's the outlook for inflation?

With so much spare capacity globally, short of a sudden spurt to global growth, it's hard to see currently falling inflation giving way to a rapid rise in inflation. At least not for the next year or so. That said inflation is usually a lagging indicator of economic activity. Inflation in the developed world fell in 2009 in response to the slump in global growth that occurred in 2008, it rose in 2010 in response to the rebound in global growth at the time and it has fallen again recently in response to slowdown in global growth since 2010. And it's no surprise that Eurozone inflation has fallen the most as its economy is the weakest and its central bank the least focussed on boosting growth and inflation.

So following this pattern, if global growth continues to improve in the year ahead then inflation should at least stop falling. On this front the US and Japan are perhaps the least at risk as the Fed and the Bank of Japan are the most focussed on pushing up inflation. The Eurozone is the most at risk of deflation as its recovery is the weakest and the ECB has been less aggressive reflecting the difficulties in getting agreement across countries that are very disparate in terms of their performance. But the ECB does seem to be getting the message that inflation is way below target with this month's surprise rate cut and has signalled that it is prepared to provide more stimulus.

So on balance there are grounds for confidence that deflation will be avoided. Rather the outlook suggests low inflation over the year ahead, followed by a possible pick up in 2015. But again with so much spare capacity around a sharp rise in inflation looks to be years away.

What about Australia?

The inflation outlook is a bit more confused in Australia because of the influence of the downtrend in the $A which is boosting import prices and concerns that non-traded inflation (ie inflation in the part of the economy not much exposed to global trade) has remained high. And of course Australia has not experienced the deep recessions other developed economies have so spare capacity is much less in Australia. But inflationary pressures are still weak in Australia:

- Headline and underlying inflation are both running in the bottom half of the RBA's 2-3% inflation range.
- Non-traded inflation is relatively high at 3.6% over the year to the September quarter, but this largely reflects the influence of price increases heavily influenced by government with: property rates and charges up 7.9%, utility prices up 5.7%, health costs up 4.1% and education costs up 5.5%. Prices for market related goods and services ex volatile items are up just 1.6% year on year and retail price inflation is just 0.3% year on year.
- Finally, wage increases are very low with wage costs growing just 2.7% year on year.

All this suggests inflation pressures are also weak in Australia. But outright deflation looks unlikely as the $A continues to trend down (likely on its way to around $US0.80 over the next few years) and growth picks up a notch. So the most likely outcome for the year ahead is for inflation to remain in the low end of the RBA's target range.

What does it all mean for investors?

If we are wrong and sustained global deflation does take hold it would favour government bonds and cash over assets like equities, property, commodities and corporate bonds. While there may be concerns about governments not servicing their debts there is unlikely to be a default by major countries and the slide into deflation would push their bond yields down to Japanese levels (of below 1%) and this would generate capital growth for investors. Some like to say gold would do well in a period of deflation, but I doubt this and would see it more likely collapsing as demand for gold as an inflation hedge will evaporate in a deflationary world.

However, as discussed above the most likely outcome is that inflation will simply remain low over the year ahead with improving growth helping it bottom but still significant spare capacity preventing much of a rise. This has several implications for investors.

First, the environment of low interest rates will remain in place for some time to come. This means continued low returns from cash and bank term deposits. There are a range of asset providing more attractive cash flows than term deposits including corporate debt, real estate investment trusts, various shares and unlisted non-residential property.

Second, given the absence of significant monetary tightening a bond crash like we saw in 1994 (where government bond yields surged as central banks moved to rapidly raise interest rates coming out of the early 1990s recession) is unlikely. The most likely outcome is just low returns from government bonds reflecting their relatively low yields, with eg 10 year bond yields around 4.3 % in Australia and 2.7% in the US.

Third, as the generally easy global and Australian monetary environment continues through next year it will help underpin further good gains in growth assets like shares.

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