Edition 25 – 9 August 2010

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Inflation, deflation or just 'lowflation'?

Key points

- It is hard to see the surge in wheat prices over the last two months having anything other than a minor temporary impact on the rate of inflation.
- More fundamentally, thanks to continuing excess capacity in major industrialised countries, deflation is more of a risk than a surge in inflation.
- This means continuing low global interest rates and bond yields for some time to come.
- Deflation is less of a threat in Asia and Australia.

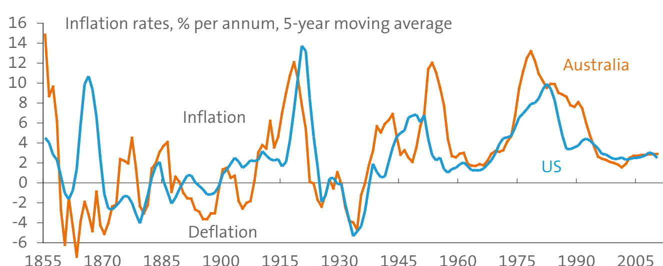
From inflation worries to deflation worries

Fears about inflation and deflation have fluctuated wildly in recent times. In late 2008, at the height of the global financial crisis, the big worry was a 'debt deflation spiral' dragging the world into depression. Six months ago, many were worried about inflation. Global growth was recovering and fears abounded that major developed countries would print money to get out of their public debt problems. However, in the last few months fears of deflation have regained the upper hand on the back of still falling inflation rates and worries about a return to global recession. Our base case is ongoing low inflation in major countries over the next few years, but the risks are skewed to deflation rather than accelerating inflation. But what is deflation? Why worry about it? Why is it more of a risk than a surge in inflation? And what would deflation mean for investors?

What is deflation?

Deflation refers to persistent and generalised falls in prices. Before the last century it was common, but with the advent of paper currencies not backed by gold and macro stabilisation policies, it became less common last century.

Deflation has been less common over the last century



Source: Global Financial Data, AMP Capital Investors

Nevertheless, there was a bout of deflation associated with the Great Depression of the 1930s. Japan has also experienced deflation since the 1990s.

Why worry about deflation?

Most people would see falling prices as a good thing because it means their income and assets will buy more. Indeed, there have been periods of 'good deflation'. For example, in the 1870-1895 period in the US, deflation occurred against the background of strong economic growth, reflecting rapid productivity growth and technological innovation. Falling prices for electronic goods are a modern day example of good deflation.

However, there can also be bouts of 'bad deflation' where falling prices are associated with falling wages, rising unemployment and falling asset prices. For example, in the 1930s and more recently in Japan, deflation reflected economic collapse and rising unemployment made worse by the combination of high debt levels and falling asset prices. What's more, falling prices can cause people to delay spending which in turn weakens economic activity.

In the current environment, deflation could cause serious problems because household debt and/or public debt levels are high in many major countries. A swing into sustained deflation would increase the real value of debt at the same time asset prices would be falling and nominal incomes and government revenue would be weakening. If individuals or governments attempt to reduce their debt burden by cutting spending and selling assets, the risk is a 'debt deflation' spiral may take hold.

Why is deflation a greater risk than higher inflation?

The standard arguments of those fearing a surge in inflation are that central banks have been printing money which will drive inflation up and governments will inflate their way out of high public debt levels. More recently, some worry that the adverse weather-related 80% or so rise in world wheat prices in the last two months signals a new bout of inflation boosting food price surges.

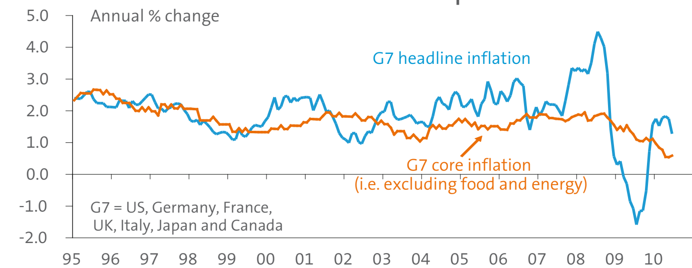
However, there are several reasons not to be too concerned by each of these. Firstly, while quantitative easing has boosted narrow money supply measures (such as cash and bank reserves), until this flows on to increased credit and spending increases to levels so the spare capacity caused by the recession is all used up, there will be no threat to inflation. In fact, there has been no increase in credit growth and excess capacity remains huge.

Secondly, it is easy to say 'governments will just inflate their way out of their public debt problems like they did after World War II'. However, this is now a lot harder to accomplish as central banks control the money printing presses and, in most major countries these days, they are independent of governments and firmly focused on keeping inflation in low single digits. Reversing central bank independence and inflation targeting will take a lot to change and so far there is no sign of it.

Finally, while the surge in the wheat price may boost food prices in the short term, weather-related surges and slumps in food prices are nothing new and usually give way to a reversal in prices six to 12 months down the track as the weather returns to normal and supply responds. So far, the surge in wheat prices doesn't appear to have led to a big flow on to other agricultural prices.

With underlying inflation rates now below 1% in the US, Europe and Japan and headline inflation rates falling again, after a brief bounce on the back of the rebound in oil prices, it is little wonder deflation worries have escalated.

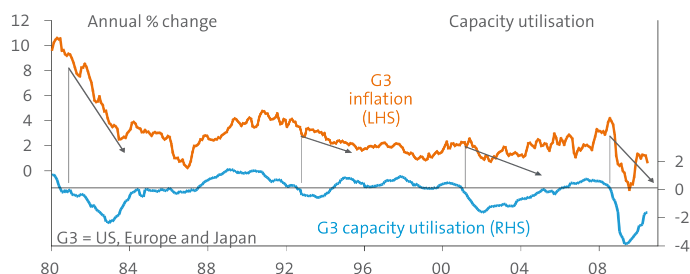
Core inflation is now less than 1% in developed countries



Source: Thomson Financial, AMP Capital Investors

The key to the inflation outlook is capacity utilisation. **The continuing downtrend in underlying inflation rates essentially reflects the normal lagged response to the global recession**. This is because the recession led to global spare capacity that still hasn't been used up. This is readily evident in the 10% or so unemployment rates in the US and the Euro-zone and in measures of business capacity utilisation. The following chart shows a measure of business capacity utilisation averaged across the US, Europe and Japan. It can be seen that it fell well below normal levels during the 2008-2009 recession. Historically, as long as it is below normal levels (the zero line in the chart) inflation has continued to fall or remained weak. While capacity utilisation has recently improved, it has only increased to levels associated with the early 1980s and early 2000 recessions, levels that still saw inflation fall. Now with global growth slowing, it will take even longer to get back to normal levels of capacity utilisation, so spare capacity will be with us for some years to come implying ongoing downwards pressure on consumer prices.

Massive excess capacity suggests deflation is more of a risk than inflation



Source: Thomson Financial, AMP Capital Investors

The bottom line is that as long as the recovery in major developed countries remains slow and excess capacity both in industry and labour markets remains, inflation will likely fall. If the major economies return to recession, the risk of deflation will escalate.

The risk of deflation varies between regions. Japan is already in deflation. The risk is highest in Europe due to the region's recent fiscal tightening and the European Central Bank's hardline approach to monetary policy imply a greater risk of a faltering in the European economic recovery. By contrast, countries in the Asia-Pacific region have had stronger economic recoveries, have less spare capacity and have higher inflation rates to begin with (implying a greater buffer against deflation), and so the risk of deflation is much less. **Deflation is also less of a risk in Australia** as there is less spare capacity, unemployment is low and a range of factors including increases in utility charges, health costs, rents and local government rates are boosting common perceptions of the cost of living. But global deflationary forces will nevertheless have a dampening impact on the local inflation rate via lower import prices, particularly if the Australian dollar remains strong.

But how likely is a sustained bout of deflation?

While the risks of deflation exceed those of higher inflation, a sustained bout of Japanese-style deflation is unlikely.

- Firstly, while goods price inflation may fall, services price inflation is relatively resilient because it has a higher wage element and wages are often sticky.
- Secondly, central banks, including the US Federal Reserve, are likely to step up the pace of quantitative easing if the risk of deflation increases. This is likely to include more aggressively buying government bonds.
- Finally, while comparisons with the US today and Japan over the last twenty years are common, there are big differences. In particular, the US has moved more quickly than Japan did to stimulate its economy. Also, the US corporate sector today is in good shape unlike the Japanese corporate sector of the 1990s, so there is less pressure to sell assets and cut business investment.

Implications for investors

As a general rule, deflation would favour government bonds and cash over equities, property and corporate bonds for investors and defensive shares with good pricing power (such as utility stocks). Fortunately with share market earnings yields, commercial property yields and corporate bond yields now well above government bond yields, it could be argued that the risk of deflation is partly factored into these assets. While deflation is not our base case, the significant risk of its occurrence in major developed countries implies interest rates will be maintained at low levels well into next year and bond yields will likely remain low despite worries about high public debt levels.

Conclusion

Our base case is that inflation will remain low as more aggressive quantitative easing and sticky services prices will prevent an outbreak of sustained deflation. However, with global spare capacity remaining high, at this stage the risks are still skewed to deflation rather than a surge in inflation. This in turn means it is still too early to get particularly bearish on government bonds.

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