



US deflation, Australia inflation – the balancing act

Widespread falling prices might sound like a good thing, but not so. US authorities are getting focussed on the risk of deflation, while Australia is more concerned about keeping the lid on inflation. In this Point of View, AXA's Chief Investment Officer Mark Dutton puts the current issues into perspective for investors.

Deflation – cheaper isn't always better

After decades of fighting the inflation beast, the US Federal Reserve is now attempting to give it a prod. The right balance is critical to the next stage of the US recovery, which depends on increases in consumer spending and improvements to the currently high unemployment rate.

An environment of persistent deflation (falling prices) could jeopardise these outcomes.

US inflation has fallen well below 1 per cent and is already negative on some measures.

This has prompted the US Federal Reserve to consider another round of quantitative easing to increase the money supply and help boost demand.

Quantitative easing sounds much more official than 'printing money', although that's effectively what it is.

Technically much of the 'new' money is created electronically with the US Federal Reserve crediting its own account ex nihilo (out of nothing).

The new money is used to purchase financial assets, such as government bonds, agency debt, mortgage-backed securities and corporate bonds, from banks and other financial institutions.

This in turn injects funds into the broader economy, boosting demand.

While quantitative easing is not a new policy measure, this is the first time the US Federal Reserve has signalled it intends to use this approach with the explicit intention of raising inflation.

Potential risks and lessons

The major risk to any of these types of policy adjustments is overshooting. And quantitative easing is much harder to reverse than adjusting interest rates.

For the US, the risk of not succeeding in pushing inflation higher would be a worse outcome than overshooting

US banks are still dealing with loan defaults and consumers attempting to repair their own balance sheets.

Deflation would be bad for borrowers because the 'real' value of debt and 'real' interest rates rise at the same time as asset values fall.

The US dollar is the main immediate casualty of this situation. Since the Federal Reserve first outlined its intention to launch a new round of quantitative easing, the US dollar index has fallen more than 5 per cent.

A weak currency is a two-edged sword. The price of imports increases and the price of exports decreases.

For the US economy, this is continuing to be a strong positive. The weaker \$US has contributed to the US becoming one of the most export-competitive economies in the world at present.

Lessons from history

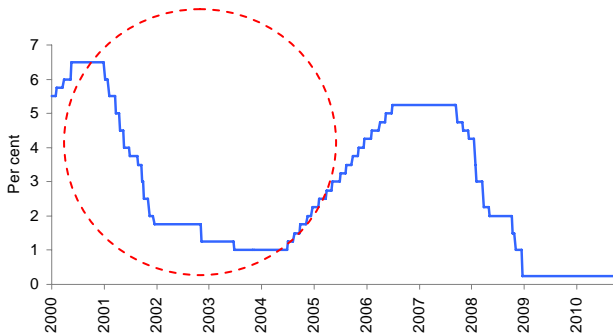
Too much 'easy money' ultimately leads to distortions in risk taking and the allocation of capital.

After the technology bubble burst in 2000 and the US economy slid into recession, the US Federal Reserve kept rates very low for five years as shown by figure 1 over page.

While the policy provided stimulus, we all know what happened next. Low interest rates enticed millions to buy homes they couldn't really afford, and saw excessive gearing across the broad economy. The repackaging of debt into market securities set up a recovery built on a house of cards.



Figure 1: US official cash rate



Source: Bloomberg.

Figure 2: Australian dollar flirting with parity



Source: Bloomberg.

Australia's situation

Australia is in a very different situation to the US. Our stronger financial position and closer links with Asia, particularly China, mean that the Australian economy is running near to capacity.

In contrast to the US, the RBA has raised interest rates six times since reversing monetary policy a year ago, bringing the official cash rate to 4.5 per cent.

The strength of our economy, surge in commodity prices and relatively large interest rate differentials between Australia and much of the developed world, have driven the Australian dollar to new highs against the US dollar, as shown by figure 2.

The RBA has noted that recent rises in the exchange rate would help keep underlying inflation within the target range of 2 – 3 per cent over the near term, but that interest rates would need to rise further at 'some point' if the economy continues to grow as expected.

What this means for investors

The stronger Australian dollar is a mixed blessing for Australian investors in overseas markets. On the one hand it's less expensive for investors to purchase overseas shares. But for investments already held, the stronger Australian dollar detracts from gains made on overseas markets when the returns are converted back to local currency.

We are certainly getting to the point where anecdotal evidence suggests that the Australian dollar should not rise much further, or distortions may become serious.

Most long term 'fundamental' valuations suggest that our currency is somewhat overvalued. For investors, diversification, including a spread of global assets looks to be worth considering and may be a good way to take advantage of the strong Australian dollar.

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