

How big a threat is inflation?



Key points

- Inflation and talk of higher interest rates have replaced the credit crunch as the main worries for investors.
- Food and energy are now the main drivers of higher inflation, although it is broader in Australia and parts of Asia.
- Our assessment is that inflation will decline as growth slows and 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 and rising unemployment. But how real is the threat?

Inflation is up virtually everywhere

| Inflation rate (% year-on-year) | Latest (%) | |
|---------------------------------|------------|--------------|
| | 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

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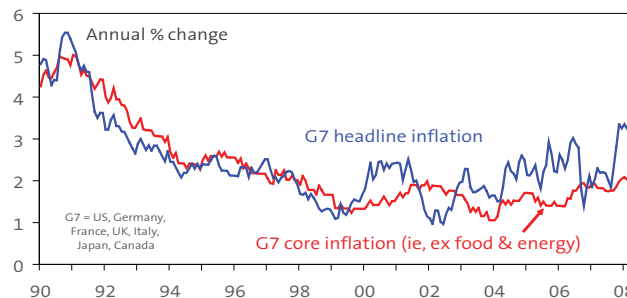
Reasons for concern

While today's inflation rates are far below the levels of the mid-1970s, there's cause for concern. **Inflation is up almost everywhere and above target in most rich countries. This is leading to a rise in inflation expectations which threatens second round effects.**

Key drivers

Surging food and energy prices are the common factors behind rising inflation worldwide. For example, in the G7 economies, average headline inflation is above 3% but core inflation (ex food and 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 RBA's measure of underlying inflation was running at 4.3%. Nor can imported inflation be blamed. Prices for items determined globally rose 3.3% over the year to March while prices for items determined in the domestic economy rose by 5%. It appears that the boost to national income from surging commodity prices has flowed through to domestic spending. This has allowed price increases to flow through to a broader range of areas. Asia has also seen a more broad-based pick-up in 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, strong demand, waning excess capacity from the late 1990s Asian crisis and undervalued exchange rates have seen underlying inflation rise in several Asian countries, although not so far in China.

Reasons to expect inflation to fall over the year

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, for the following reasons, it is hard to see it going too much further.

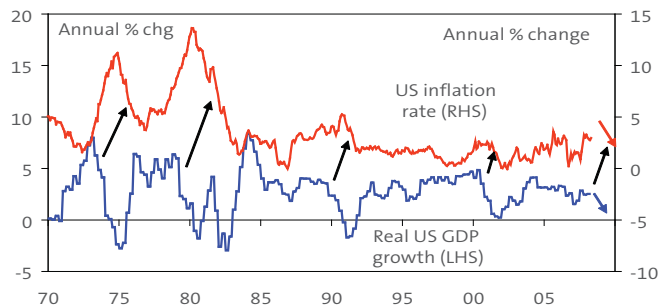
- **Despite the surge in food and energy prices in the 1970s, there are big differences between now and then which should**

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prevent high inflation becoming entrenched. We've not seen the huge productivity zapping expansion in government that occurred into the 1970s. The global economy is now far more competitive. Labour markets are largely deregulated, union membership is down sharply and centralised wage-setting here is a thing of the past. Central banks have taken monetary policy away from politicians and inflation targeting has helped to anchor long-term inflation expectations. Furthermore, financial market deregulation means the consequences of allowing high inflation are quickly made apparent in the form of higher interest rates or a falling currency.

- 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.

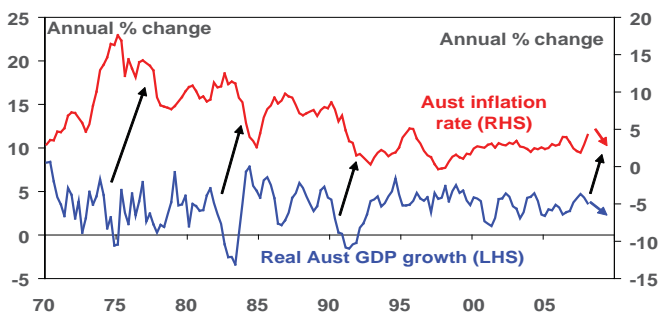
US growth slumps normally lead to lower inflation



Source: Thomson Financial, AMP Capital Investors

This will also be the case in Australia, where a sharp slowdown in a range of economic indicators – housing finance, housing starts, consumer and business confidence, retail sales, employment etc. – indicates that the RBA is now seeing the desired downturn. If history is any guide, this will lead to lower inflation.

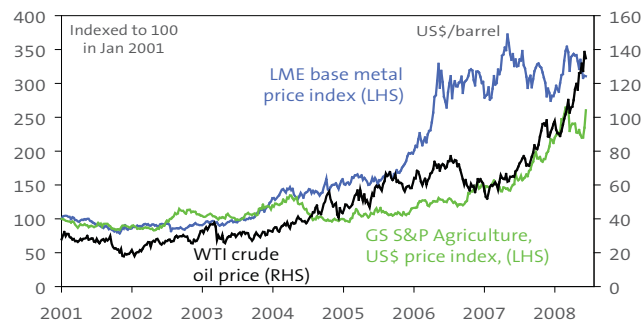
The Australian growth slump is likely to lead to lower inflation



Source: Thomson Financial, AMP Capital Investors

- Inflation became so entrenched in the 1970s as higher fuel and food costs fed into wages growth, creating a wage price spiral. There's no evidence of this today. **Wages growth in most countries is relatively benign.** With economic growth slowing, it is hard to see it picking up. **Locally, the softening labour market means that the risk of a wages breakout is rapidly receding.**
- Some short-term relief in food and energy prices is likely. 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. After going exponential into early this year, agricultural commodity prices 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 be range trading as slowing global growth cuts into oil demand, leading to an unwinding of speculative positions. We see the oil price falling to about US\$100 a barrel sometime in the next six months. This will cut headline inflation substantially.

Rolling commodity manias – food oil due for a correction



Source: Thomson Financial, AMP Capital Investors

- 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 which will make it even harder for housing markets. Furthermore, the flattening US yield curve 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 will flow through to lower inflation.

For these reasons, we see inflation falling over the year ahead – both globally and locally. As a result, it is unlikely that central banks will raise interest rates to the extent now priced into financial markets, if at all. The ECB may be the exception, but it is hard to see a tightening in the US any time soon. The Fed has rarely tightened during rising unemployment. **We remain of the view that the RBA has done enough to ensure inflation will head back to target in a reasonable timeframe.** 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 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 hike is crazy and the next move will be a cut. This suggests that bonds are providing good buying opportunities on current elevated yields. Signs of lower inflation, oil prices and 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. 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. However, we see inflation concerns abating later this year in lagged response to slower growth and falling oil prices. This should be positive for shares into year-end.

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