December 2015

INFLATION OUTLOOK 2016
THE LAST SAFE HAVEN

REVERSION TO MEAN IS A POWERFUL FORCE IN MARKETS. FOR MANY ASSET CLASSES CURRENTLY PRICED TO PERFECTION THIS WOULD REPRESENT MATERIAL LOSSES IN 2016. FOR INFLATION, IT WOULD MEAN SIGNIFICANT GAINS, WRITES INSIGHT INVESTMENT'S DAVID HOOKER.

Switzerland, Malaysia, Poland and India have little in common, ethnically, geographically or culturally. They are, however, members of a new economic club which is becoming increasingly fashionable: the deflationists. Deflation is more on trend than safari prints and the internet of things. It is enough to make the late Milton Friedman turn in his grave. If inflation is "always and everywhere" a monetary phenomenon, how can it be that an era of unprecedented policy experimentation and central bank balance sheet expansion has coincided with falling prices?

Economics is not known as the dismal science without reason. Unlike hard science that is governed by irrevocable rules of nature, economics depends on human action. When the third plenum of the Chinese Communist Party's 18th central committee met in November 2013 and declared a new economic agenda built around consumption and imports rather than investment and exports, the effects were bound to ripple around the world. Similarly, in 2014 OPEC decided its long-term interests were to drive out marginal US shale oil producers rather than restrict supply and keep prices high.

Directly and indirectly these decisions have had a significant impact on inflation in 2015. The halving in the price of oil has helped tip net importers such as the eurozone back into deflation. The reorientation of the Chinese economy has also tipped the balance between supply and demand for a swath of commodities. The Bloomberg Commodity Index touched a 16-year low in September as the world's most heavily traded bulk commodities such as iron ore and copper slumped in price.

The knock-on effects of sharply falling commodity prices have been pronounced. Commodity-producing countries have suffered a severe terms-of-trade shock. This has been accompanied by capital outflows. Structural adjustment is difficult and often politically unpalatable so many policymakers have resorted to one of the last policy tools available to them, the exchange rate. The stronger dollar has proved a safety valve for many emerging market economies. But competitive devaluations have been another transmission mechanism for global deflation.

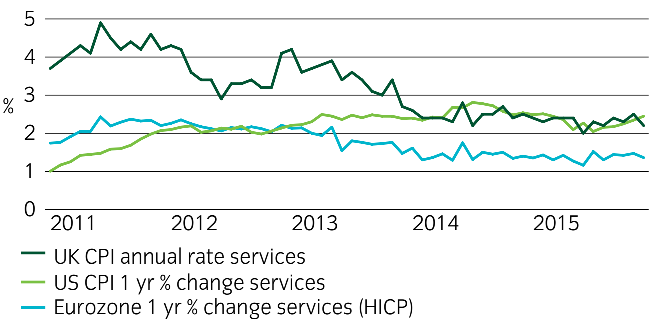
BACK TO BASES

One of the most commonplace and dangerous tendencies among analysts and investors is to extrapolate into the future from a current trend. Just because deflation has taken hold it does not mean that further falls in prices are inevitable. The way inflation is measured makes this extrapolation even more questionable than for other data series. That is because of "base effects". Annualised inflation is calculated using a base year and month. When there are sudden inflationary or deflationary shocks, they eventually fall out of the data series.

The sharp decline in oil, for example, was largely a 2014 phenomenon. Since January 2015 a barrel of West Texas Intermediate crude oil has traded in a range between around $60 and $40. If these prices remain broadly stable, the oil price will not have such a profound effect on inflation in 2016. The same is true of other commodities. They may or may not have reached a bottom, but sharp declines such as those we have witnessed recently tend to be associated with cyclical peaks in supply or troughs in demand.

The impact of commodity prices on inflation is also overstated, particularly in developed economies. The services sector accounts for almost 80% of UK and US GDP. Service sector inflation is actually above the 2% target typically set by central banks (Figure 1). In spite of this inflation is a cheap asset class. The yields on some inflation-protected Treasury bonds have doubled since April. 30-year TIPS are offering real (inflation adjusted) yields of around 1.2% a year. In other words, they are guaranteed to beat inflation between now and 2045. This reflects inflation expectations at their lowest levels in six years.

Figure 1: Services sector inflation above 2% in UK and US



Source: Thomson Reuters Datastream as at 24 October 2015.

STATE OF REPRESSION

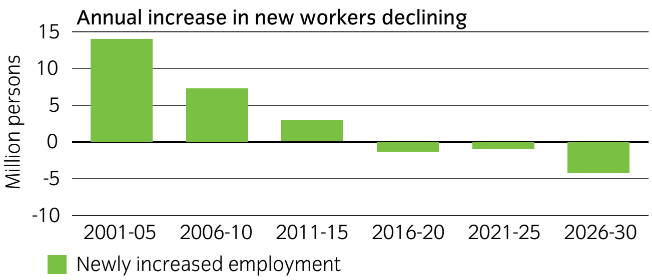
The washing through of base effects is one technical and tactical prop for inflation pricing. Broad multi-generational macro themes are also supportive. The first is demographics. One of the standard economic narratives in recent years is that inequality has increased; labour has been in abeyance and capital has triumphed. Part of the explanation for this has been the falling of the Berlin Wall and the opening of China's economy. Huge new economies have joined the global economic system and labour has suffered a supply side shock.

That is now wearing off. As a result of the legacy of the one-child policy, the Chinese workforce is declining by four million annually. Japan and Germany, with more than 20% of their populations above the age of 65, are in the doddering, grey vanguard. Japan's overall labour force began to shrink in 1998. This reduction in the labour force is likely to put upward pressure on wages.

The second macro theme that is likely to revive inflation is debt. A recent McKinsey report sums it up well: *Debt and (Not Much) Deleveraging*. Deleveraging has been honoured more in the breach than the observance around the world. Across the government, household, corporate and financial sector overall debt has been increasing – by 64% in Japan, 66% in France, 30% in the UK and a staggering 83% in China since the financial crisis began in 2007, according to McKinsey.

Central banks are very cognisant of this debt burden and are doing everything in their power to make it sustainable. The way the Federal Reserve blinked at the prospect of raising rates in September 2015 shows how attuned policymakers are to the potential side-effects of tightening financial conditions. The default setting seems to be to stay looser and lower for longer. More monetary stimulus is widely expected from the Bank of Japan, European Central Bank, and People's Bank of China in 2016.

Figure 2: Chinese demographics suggest labour will be repriced



Source: Hu Ying (2010), "demographic changes on '12th Five Years Plan' Period and Prediction for Population Development" . in Cai Fang ed. China Population and Labour Report in 2010, Social Science Literature Press.

Like most fashions, deflation could prove to be a fleeting obsession. The downward pressure on prices from a stronger dollar, collapsing commodity prices and competitive devaluations has created a perfect storm. All storms blow out. Monetary experimentation, however, is likely to have long run and entirely unpredictable consequences. What is certain is that governments and individuals around the world still face unprecedented levels of indebtedness and the authorities are running out of policy levers. Financial repression, inflating away the debt, may prove to be central banks' least worse option.

FIND OUT MORE

European Business Development
europe@insightinvestment.com
+44 20 7321 1928

@InsightInvestIM

company/insight-investment

www.insightinvestment.com

Telephone calls may be recorded.
Call charges may vary by provider.