THE AUSTRALIAN

Business
Beware the return of even mild inflation after prolonged stagnation

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764 words
7 May 2018
The Australian - Online
AUSTOL
English

Beware the return of inflation. Despite the easy stance of monetary policy around the world and the return of synchronised growth across the major economies, the dominant view of investors is that inflation won't be a problem for another decade or so.

While expectations for global inflation have recently been revised up a little on the back of higher-than-forecast increases in wages and prices in the US, the pricing of long-dated bonds currently suggests inflation in the US (and Australia as well) will average just two per cent a year over the next 10 years — and be even lower in Europe. If realised, that would be a happy state of affairs for most investors. But is it the most likely outcome? In my view, prudent investors should allow for prospects that inflation in the US will move a percentage point higher, to around 3 per cent by mid-2019.

• A little later, inflation in most other countries, including Australia, will also rise by a notch or two.

• These moves could well be the early stages of a moderate cyclical upswing in inflation that runs for several years (to a peak inflation rate of perhaps 5 per cent?).

• Given widespread expectations for near-negligible inflation, even the modest pick-up in inflation I'm suggesting in the next 12 months would cause some disruption in investment markets.

• And the return of even a mild cycle in inflation — something not seen since the global financial crisis 10 years ago — would be uncomfortable for investors not prepared for it. In times like these, it's useful for investors to think about the distinction between the trend in inflation and the cycle in inflation (though recognising that the differences can become blurred).

The trend

The trend in inflation is the average rate over the medium term and longer. In the 1980s and 1990s, trend rates of inflation dropped in many countries, thanks to central banks targeting low inflation, globalisation (including China becoming a major exporter of manufactures), technology (which, among other things, makes it easier for people to shop around for low prices) and the declining influence of trade unions. Later on, the impact from the global financial crisis was so severe that the trend rates of inflation were lowered further.

Australia's trend rate of inflation used to be much higher than inflation in most other western countries. In the 20 years to 1990, inflation here averaged 9.4 per cent a year.

Since the first half of the 1990s, the Reserve Bank has targeted keeping inflation in the range of 2-3 per cent a year over time. And they've succeeded: for the past 25 years, our index of inflation has averaged 2.5 per cent a year. My guess is the future trend rate of inflation in Australia will remain at about that figure.

The cycle

The cycle in inflation in Australia used to be much wider than the cycle in inflation in other western countries, with cyclical peaks of 23 per cent in the early 1950s and 17 per cent in the mid-1970s.

Since the early 1990s. our inflation cycle has narrowed markedly. The cyclical peak, in 2007, was 5 per cent, and we navigated through the two recent mining booms without inflation becoming the problem we had witnessed in earlier booms.

The key influences on the Australian inflation cycle these days are global inflation, the exchange rate, the tightness or weakness in our labour market, energy prices and inflation expectations (which here and abroad, have collapsed in recent years). I think there is a good prospect we won't again see inflation reach double-digit rates even over a long run of years.

In the coming 12 months, inflation here could well be quite mild — allowing our cash rate to stay unchanged or another 12-18 months even as the US cash rate is raised. (Perhaps this would help pull our dollar down, but maybe not by as much as some businesses and investors are hoping for.)

It's inflation in the US that drives global markets, particularly bond markets. US inflation seems to be picking up — not by a lot, but more than expected. Investors should keep a close watch on US data, looking for any signs the tightening US labour market will speed up wage increases.

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