Don't Bet on This Market

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In 1992, while the pound was tumbling, the Swedish central bank raised interest rates to 500% to prevent facing the same fate. “Want to make a grown nerd cry? Run that interest rate through his risk model,” wrote Eric Peters, the CIO of One River Asset Management.

But it wouldn’t take the 500% which he recalls to make risk models blow up. And the men who manage them cry. Thanks to the huge increase in debt, a return to more or less normal rates would be enough to cause huge crises in all of the world’s financial markets.

Governments wouldn’t be able to afford their interest bill. At least not eventually. They rely on “rolling over their debts”, which means paying off old debt that comes due with new borrowings. While interest rates remain extraordinarily low, they are constantly refinancing the existing debt at lower rates at a slow but steady pace – a huge financial advantage.

Higher rates would suddenly expose that this phenomenon works both ways. The interest bill would slowly but steadily rise as the old debt is rolled over at ever higher rates, and the new deficits are financed at higher rates too. Even if the deficit is reigned in, having to refinance the existing debt mountain at higher rates remains a problem.

Companies are in much the same situation. But many of them finance on floating rates, making the shock more immediate.

For the consumer, the rising price of debt would cause another house price crash.

But none of this could possibly happen, because central bankers control interest rates, right?

An accountability comeback

The British Retail Consortium reports that we’ve had our third consecutive month of retail sales growth. Good news? Economics ain’t that simple.

The sales figures rose not because of increased selling of stuff, but because of rising food prices.

Inflation, the age-old accountability mechanism of central bankers, might be making a comeback. If it did, that would put pressure on central bankers to tighten monetary policy regardless of the state of the economy.

Historically, when central bankers were too loose, they’d trigger inflation. But the biggest monetary policy response in history hasn’t brought on an increase in prices. At least not in consumer prices. Inflation in financial markets has been impressive.

The absence of their accountability mechanism meant central bankers could do as they pleased this last decade. And they did, with trillions in new money flooding financial markets around the world.

But if inflation makes a comeback before the economy is ready for it, central bankers will once again return to making more difficult choices. They’ll have to decide which mandate is most mandated. Inflation, employment or financial stability?

If you can pick the one they’ll chose, you’ll know how to invest. And that will be one focus of my speech at our 6 October conference. I hope you’ll join us.

The inflation warnings

So how do you know if inflation will make a comeback?

Well, it depends on your definition of inflation.

Are price increases inflation? If supply and demand drive those price increases rather than monetary devaluation, then signifying them as inflation is misleading. But for you and me, it feels the same. As for financial markets.

And so the first thing to watch is the price of oil. Inflation tends to hit commodities and energy prices early if not first, making them a major feature of the changing cost of living we actually feel.

But the oil price is hardly moving. And “metals prices are saying a global recovery is afoot” reports John Authers at the Financial Times:

> *The Commodities Research Bureau’s Raw Industrials index, known as the Rind, has rallied more than 30 per cent since late 2015 with a surge in recent weeks. Copper, the most closely watched industrial metal, is up 58.5 per cent since its nadir early last year and has gained more than 20 per cent in a rush since midsummer.*

Good news. Unless it’s inflation that’s driving the trend instead of a recovery.

Over in the US, the Federal Reserve has once again been saved by a crisis. Facing the prospect of having to tighten monetary policy, leaving the government, business and consumers with a higher interest bill, Hurricane Harvey came along.

The storm is expected to lower growth and raise inflation, but only temporarily. The Fed has the excuse it needs to delay the rate hikes which were potentially coming in September and October. This sort of surprise keeps happening just when the Fed is expected to tighten.

And of course there’s the effect Harvey had on the oil price, showing how hard it is to tease out inflation from the market action.

Last but not least, making life really confusing, is the role currencies play in all this. The falling pound thanks to Brexit could be the primary cause for the high inflation, making a policy response misguided.

If inflation is returning to the world economy, risking the tightening of monetary policy, it’s doing so in disguise.

Until next time,

Nick Hubble
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