US INFLATION PUTS THE FED UNDER PRESSURE

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Over the past three decades central banks have targeted low inflation to sustain the economic cycle, but since the financial crisis they have been battling to lift inflation back to their official targets, despite record stimulus. This is due to the world's excess capacity not being addressed and debt continuing to rise. Consequently, whether recent central bank policy decisions will finally lift growth and inflation remains unresolved. However, Matt Sherwood, Perpetual's Head of Investment Strategy, Multi Asset remains sceptical as the world remains in a liquidity trap which means that fiscal policy and structural reforms are more important in improving the macro outlook. However, the latest US core inflation read is at the top end of the US Fed's 2016 range with broad rises in goods and services despite a strong US dollar. This has investors questioning the efficacy of their recent policy guidance and the sustainability of the recent market recovery. A further acceleration in US inflation will force the Fed's hand and have policy tightened faster than expected. The combination of weak global growth, high valuations and a hiking Fed makes it harder to see strong returns in risk markets in 2016.

KEY TAKEOUTS

- There are very few large economies which have core inflation above their central bank's target and the ones which do typically are commodity exporters that have suffered large currency depreciation. However, US inflation is now stirring, but the US Fed has just wound back their policy guidance with the primary complicating factor being the emerging markets who have invested heavily in capacity which has proven to be redundant. This has placed upward pressure on the US dollar and reinforced the regional disinflationary trend. Accordingly, advanced economies will need low interest rates and countries with large manufacturing bases (such as Europe and Japan) may prove as hard for policymakers to navigate, as ones that are deleveraging.
- Headline inflation is almost certain to rise in 2016 as oil prices cease declining, but core inflation is likely to rise only in the US. US core inflation is at multi-year highs despite the very strong US dollar and the fact that US growth has exceeded its potential in only one of the past five quarters due to tightening financial conditions. Over the past 130 years inflation has been constructive for shares, delivering 40% of total return, although this relationship broke down in the 1970s. The key for investors is where the inflation comes from – if it emanates from the supply side it leads to lower profits growth and a higher cost of capital, but demand side inflation leads to higher wages and higher profits which help ease debt burdens.

INTRODUCTION

Central banks have been attempting to control the stability of their economies for many generations through numerous channels. In the 200 years to 1971 money creation was typically anchored to the price of gold, but after President Nixon removed America from the Bretton Woods system in 1971, central banks managed the money supply growth. After this approach broke down, they decided to directly target low inflation. Unlike other methods, low inflation is readily observable, which means that it is easier to anchor private sector expectations. In Australia, the Reserve Bank targets 2%-3% over the business cycle, which is a more flexible target given our oscillating exchange rate's impact on consumer prices, and most other major central banks have similar targets over a shorter timeframe.

WHY TARGET INFLATION?

Twenty five years ago high inflation was considered to be costlier, in economic terms, than low inflation as the former can generate distortions in the economy, reduce productivity, generate a more volatile economic cycle and culminate more frequent recessions. Interestingly, low inflation is not without its risks as firms can't cut wages in most cases when recession strikes, but if inflation is high, then the real cost of labour can fall even if actual wages don't (because workers become cheaper relative to the goods they are producing) - so firms face less pressure to reduce workers in a downturn.

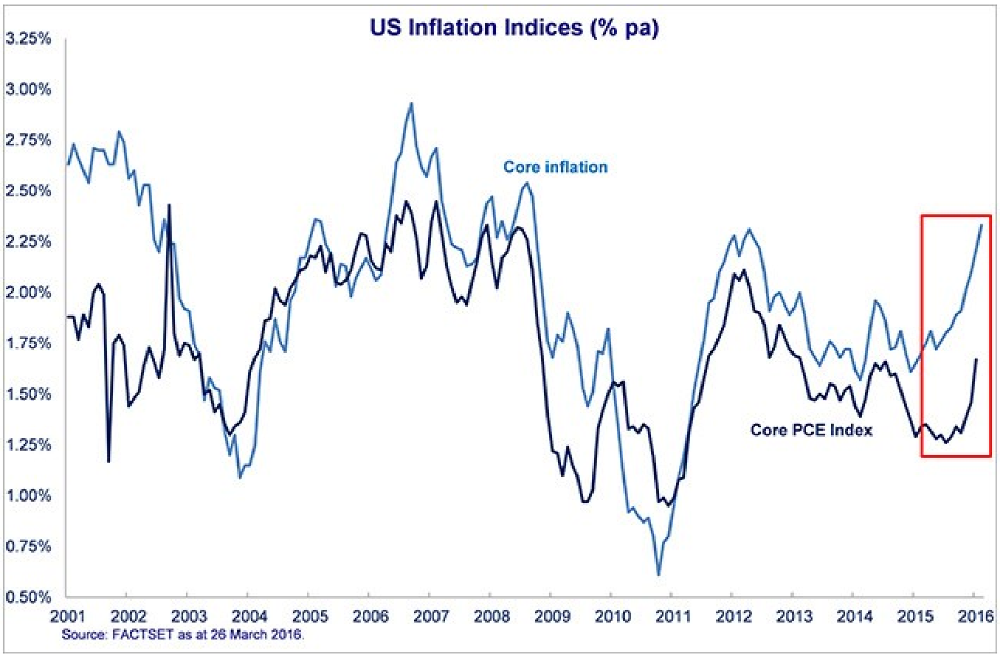
TWO DRIVERS OF GLOBAL DISINFLATION

Over the past five years, global inflation data has disappointed expectations for two key reasons. Firstly, lower global oil prices placed large downside pressure on headline inflation, but this impact will fade if crude prices only stabilised for 12 months at their recent lows. If this occurred it would see global headline inflation rise +1% and return to positive territory. The second factor is more structural in that the relationship between core US inflation and US unemployment weakened (where a 1% decline in US unemployment led to a 0.01% lift in core US inflation in the 20 years to 2015, relative to 0.31% in the 20 years to 1995 – source Minack Advisors) as did its relationship with wages growth. This indicates that domestic US inflation is more than a US economic story, which is not surprising in the wake of globalisation.

2% INFLATION AND AN IDLE FED?

There are few large economies which have core inflation currently above their central bank's target and the ones which do tend to be commodity exporters that have suffered large currency depreciation. Similarly, core inflation is typically well below targets in countries that are importers of raw materials, and despite tighter labour markets in rich countries, wages are not rising very fast. Inflation normally rises aggressively at the end of each cycle and core US inflation (at +2.3%) is at its highest level since the GFC and at a rate that has rarely been exceeded in the past 15 years. The US Fed's preferred inflation gauge (the personal consumer expenditure index (PCE)) is at a three-year high (see Chart 1) with a broad-based price rise in both the goods and services sectors, despite the very strong US dollar and the fact that US growth has exceeded its potential in only one of the past five quarters as financial conditions tightened. Yet despite US inflation rising to multi-year highs, the US Fed has just wound back policy hike expectations.

CHART 1: US INFLATION MEASURES ARE AT MULTI-YEAR HIGHS



IS THE US FED REPEATING PAST MISTAKES?

While very low inflation make an economy more vulnerable to a slide into deflation, winding back policy expectations as inflation is structurally rising can be equally unproductive. The US Fed's downgraded guidance begs the questions of whether the US central bank is once again raising rates too slowly and too late and risking a sharper economic slowdown in the years ahead. A central bank would normally have a neutral policy stance (where policy settings neither adds to nor detracts from the cycle) before an economy is operating at full employment. It is clear that setting monetary policy is more complicated in the post-GFC world, especially in light of all the excess liquidity swashing around the global financial system given the engorgement of central bank balance sheets. A synthetic measure (derived from bond prices) puts expected US consumer-price inflation at 1.8% pa over the next five years, which is extremely low on an historical basis. This measure has a strong relationship with energy prices, and, even if the oil price only stabilises at recent lows, it will spark higher expectations going forward, which suggests bond yields could rise.

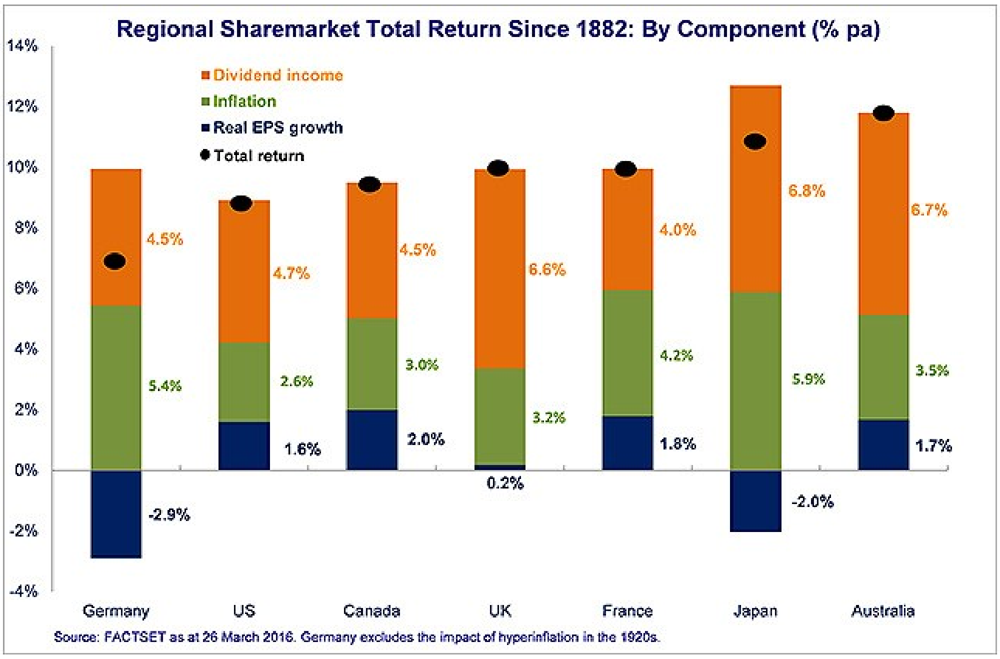
THE COMPLICATING FACTOR

Although the US Fed operates monetary policy with respect to domestic growth and inflation, the globalisation of markets has meant that it needs a broader information set. The primary complicating factor for the Fed is the emerging market credit binge over the past seven years which had many of these countries follow similar industry policies by building mines and factories in expectation of structurally strong Chinese growth. These investments have proven to be redundant and capital outflows has placed upward pressure on the US dollar, which has reinforced the global disinflationary trend. Consequently, advanced economy policymakers will keep their domestic economies primed with low interest rates to offset disinflation from abroad, as was the case in the 1990s, and advanced economies with large manufacturing bases (such as Europe and Japan) may prove as hard for policymakers to navigate as ones that are deleveraging.

INFLATION AND THE SHAREMARKET

Low inflation means that companies, households and governments have a harder time reducing debt as the private sector delays spending decisions and wages growth declines. However, the relationship between inflation and sharemarket returns is multi-faceted as high inflation leads to higher earnings (as EPS growth is a nominal concept) which is constructive for returns, but it also culminates in a higher cost of capital, which weighs on total return. Nevertheless, history shows that inflation was around 42% of total sharemarket returns since 1882 in both lower returning markets (Germany, US, Canada and the UK) and their higher-returning peers (France, Japan and Australia – Chart 2).

CHART2: INFLATION - 40% OF LONG-TERM EQUITY RETURNS



THE INFLATION SOURCE IS THE KEY FOR INVESTORS

Some investors believe that the 1970s discredited the belief that shares are a good hedge against inflation. However, the prospect for shares instead depends on where any inflation comes from. In the 1970s inflation came from the supply side of the economy and, as such, led to lower profits growth and a higher cost of capital, but most other periods it came from the demand side and therefore led to higher wages, higher profits and eased debt burdens which was constructive for investors, as long as the income gains were spent.

IMPLICATION FOR INVESTORS

While headline global inflation is likely to rise in 2016, the world remains subdued and core inflation is only likely to lift in the US. US inflationary pressures are stirring on all measures and the US Fed tempering its policy guidance is symptomatic of central banks becoming increasingly harder to read as the global picture has become more clouded with improving labour markets offset by continued weak economies. It has taken eight years of record stimulus to have US core inflation trending towards the Fed's target and this may force their hand in terms of the pace of required rate hikes. A key question for investors is whether rising wages growth is good for EPS growth as it leads to higher consumption, or bad for shares as it leads to lower margins and a higher cost of capital. I think rising US inflation is a net negative for shares as the US market has been driven by EPS growth since 2011, which will moderate and likely extenuate the recent global earnings recession. In addition, non-US markets have been underpinned by falling global interest rates, which will cease, at least in the US. Consequently, investors need to remain cautious as the exit from unconventional policy is unlikely to be smooth. The key here is income which has provided a larger slice of total return than inflation since 1882 (an average of 56% across all regions) and has considerably less volatility than price growth.