M&G Multi Asset team

The real reasons we shouldn't be worried about inflation

Over the past few weeks, inflation data from around the world has, in some cases surprisingly but in others not, continued to show a very slow rise in consumer prices. Predicting where inflation could go in the next few months would be an impossible exercise; that said, we believe the consensus is probably right to be untroubled by inflation in the immediate future. However, we think many market participants are struggling to understand the real drivers of low inflation. As a result, markets could continue to be surprised by lower inflation for longer than expected. This could have important consequences for investment decision-making.

Are inflation models still reliable?

Inflation numbers released during the past few weeks continued to confirm a relatively slow rise in consumer prices. European Harmonised Indices of Consumer Prices (HICP) annual numbers came in slightly above expectation (0.8% vs 0.7%), but still below the 1% threshold for the fourth consecutive quarter.

In the UK, the market was surprised by the sustained fall in inflation to 1.9% – below the Bank of England's target level. In the US, the Consumer Prices Index (CPI) is still comfortably below the 2% level at 1.6% year-on-year, having moved in the 1-2% corridor over the past 10 months.

How should we interpret this data and how can inflation affect our investment decisions?

The generally accepted wisdom on the topic of inflation tends to be that in the long run there is a strong link between the growth rate of money supply and inflation. In recent years, many people have been left scratching their heads as to why massive monetary stimulus programmes across the world since 2008 have not fuelled rising core/underlying inflation. Instead, so far, inflation has been the fear that never materialises. In light of this, observers have to ask themselves – have I got the right model?

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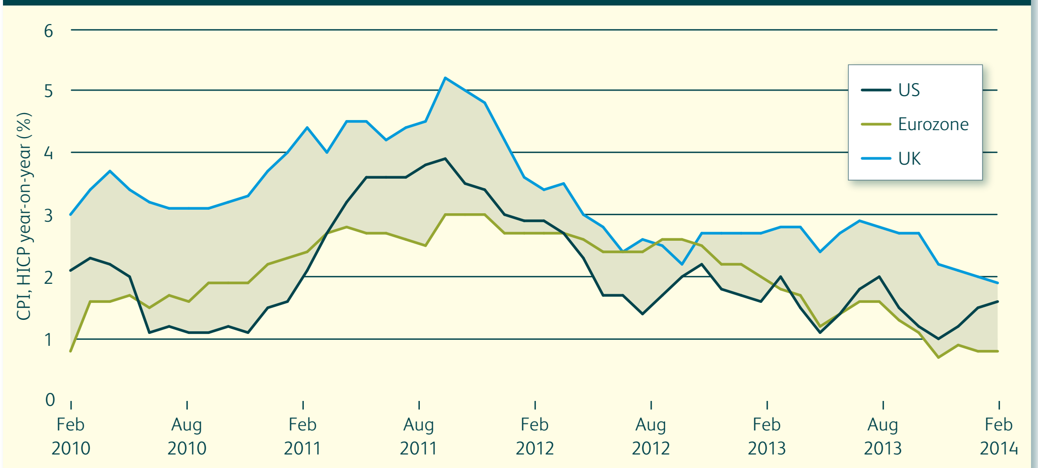
Falling inflation



Source: Bloomberg, as at 31 January 2014.

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In our view, most models of inflation are not working and have not done so for some time. For example, assertions such as "rising oil prices will create inflation" or "printing money will create inflation" have not come to fruition, yet people still seem anchored to the consensus that inflation will somehow appear on the back of growth stimulation. Perhaps observers need to rethink their assumptions about the cause and effect of inflation.

Growth may not equal inflation

Most people seem to think that low inflation is quite simply the effect of a persistently below-par global economy on the labour market and, therefore, on demand. In other words, if consumers do not have money to buy things, prices stay down. The implication then is that if demand is stimulated, we will get growth and then we will get inflation. From a theoretical standpoint, all the ingredients are there for a strong pickup in inflation: monetary stimulus, low interest rates, increased monetary base and hikes in oil and food prices. However, despite the improvement in growth that we are already seeing in many countries, inflation levels remain stubbornly low.

One of the reasons behind this 'broken' mechanism could be that the crisis we experienced in 2008 had a larger impact on our society than we initially might have thought. Banks have used the extra liquidity provided to restructure their balance sheets, rather than lend more. Similarly, companies have used debt issued at very low yields to pay dividends and buy back shares rather than increase investments or make acquisitions. Even individuals have used the extra cash (if available) to reduce their 'leverage' rather than consume more.

The consequence of this 'unwillingness to spend' has been that money velocity (that is, the speed at which money passes from hand to hand) has decreased, and therefore the impact of a larger monetary base has been reduced significantly and did not drive an increase in inflation.

Furthermore, there remains a considerable amount of 'excess capacity' in developed market economies. Excess capacity describes the situation in which actual production is less than what is achievable. This often means that demand in the market is below what could potentially be supplied. In this environment, price inflation will likely be lower than the level we would expect during periods when an economy is operating at its full or close-to-full productive capacity. If producers increase supply, or in other words, ramp up their output, we may see economic growth, but crucially, we may also see downward pressure on prices. Therefore, the same thing that would cause stronger growth would cause lower inflation – an increase in supply.

Globalisation and new technologies

Two important aspects that, in our view, have a significant impact on both supply and inflation are the 'globalisation' of the economy and the significant technological advancements we have experienced in recent decades. Those two factors combined have a major effect on prices.

First of all, a more globalised economy means that companies and individuals are able to source goods from around the world at the lowest possible price. The opening of frontiers reduces the issue of scarcity of goods and keeps prices low. *Think about buying strawberries in December: for our grandparents this would have been an incredible luxury, while today, it is commonplace.*

The other important change is linked to the improvement of technology and the role it has in our everyday lives. Internet search engines make it extremely easy for people to compare prices and source the cheapest available item, which makes it more difficult for some companies to increase prices. Online shopping, for example, is becoming more and more popular and people have access to a greater amount of information. *Think about booking a hotel for your next holiday: the ability to compare location, prices and reviews on quality is so significant that it is nearly impossible for any hotel within the same location to charge higher prices without being noticed.*

One of the consequences of this improved price transparency and easy availability of products is that prices are 'stickier' and it is more difficult for sellers to raise them.

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Headline versus core inflation: There has been some debate about which measure of inflation is the most reliable indicator of economic conditions and central bankers around the world have taken different views on the matter. 'Headline' inflation is calculated from an all-item index, while 'core' or 'underlying' inflation refers to the long-run trend in the price level, excluding areas which may experience sudden inflationary spikes such as food and energy. This is because, historically, the food and energy components were highly variable (for example, due to temporary supply disruptions), and their large price fluctuations were usually expected to correct themselves within a relatively short period of time.

New inflation dynamics

The significant changes that society has been through over the past few decades – and more recently after the credit crunch – are so deep and profound that they are shaping the way economic dynamics work.

Low inflation, combined with the relatively modest recovery we have seen so far, leaves room for central banks to remain more active in helping the economy to expand. Therefore, understanding the factors that could impact inflation is an important part of investment decision-making.

The sort of loose monetary policy we have seen central bankers implement in recent years is a demand-side solution – it injects liquidity with the aim of increasing aggregate demand in order to stimulate growth, but has so far seemed to be only partially successful. Growth has not been as important in driving inflation as we might have typically expected in the wake of previous financial crises.

It may be action on the supply-side, rather than the demand-side, that will ultimately stimulate growth. Our view is, if anything, the global economy is increasingly competitive due to both technology and the spread of 'free market' ideology. Increasingly more countries are reforming and deregulating. Together, this puts pressure on the ability of price inflation to persist. As such, we think growth may push inflation even lower. This may mean we probably will not need to fear inflation for some time to come – which could surprise a lot of people.

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