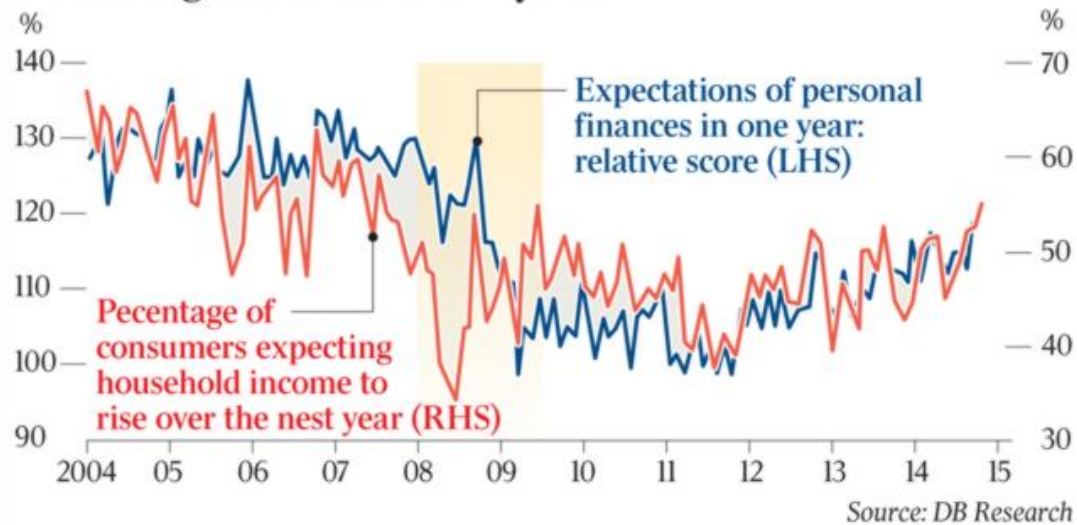


New global upswing could usher inflation sooner than expected

- DON STAMMER
- [THE AUSTRALIAN](#)
- NOVEMBER 04, 2014 12:00AM

In the US, wage and income expectations are the highest levels in five years



US wage and income expectations. *Source:* TheAustralian

RECENTLY, investors had a stark reminder of how quickly sentiment in investment markets can swing from one extreme to the other — and, on this occasion, back again.

The sense of calm that had been the dominant mood of investors for much of the year was fractured in mid-October by full-on concern world growth was stalling — and inflation in the major economies would morph into deflation. Bond yields dropped, share prices plunged.

Soon, stronger numbers on the US and Chinese economies and better-than-expected quarterly financial reports from US companies brought a return of confidence. US shares made their strongest one-week gain for the year; other sharemarkets moved higher.

Investors need to allow for further changes in market sentiment — some of which will have lasting effects. Take inflation, for example. Investment markets are currently priced for entrenched low inflation. But might the negligible rates of inflation in the major economies reflect as well as structural influences? Is inflation extinct ... or hibernating?

Currently, global inflation is unusually low: economies have a lot of slack; fear of unemployment is restraining wages; the increased money supplies generated by ultra-accommodating monetary policies are being added to idle balances rather than circulating; and global energy prices have fallen, thanks to US shale oil and gas and the slowing global economy.

Looking ahead, there's significant risk of a cyclic increase in global inflation — with the lead coming from the US. The US unemployment rate, as usually measured, has fallen by four percentage points. The US Fed expects many people who've dropped out of the labour force to return to work as the economy strengthens; as a result, inflation isn't an immediate problem and the Fed can delay increasing its cash rate for another year or so.

If it turns out that the ageing US population is the main cause of underemployment there, the Fed's monetary policy is likely to be viewed as "too easy for too long", the inflation genie will be on the way out of the bottle — and the Fed's credibility will tank.

As the chart shows, US wage and income expectations are at their highest level for five years — so maybe the discussion we should be having is not if we will see higher inflation but when.

With US banks having rebuilt their balance sheets, there's scope for the circulation of credit to start speeding up and readily accommodate a cyclic rise in inflation.

With bonds priced for decades of low inflation — 30- year US government bonds are yielding 3.1 per cent — even a hint of inflation in the US would likely be unsettling in bond markets. Indeed, should US inflation run above the target rate of 2 per cent a year for two or three quarters, an aggressive and sustained bear market in bonds could begin, in the US and around the world.

In Europe, sentiment in investment markets is still that low inflation could soon morph into deflation. In both "core" and "peripheral" countries of the eurozone, bond yields have recently been at record lows.

There is an assumption that inflation is likely to return to Europe only after it reappears in the US. However, it's entirely possible the dissipation of thoughts of deflation could drive eurozone bond yields higher.

Unexpected inflation, even moderate inflation, has complex consequences on investors. Assets with a fixed money price lose value. Funds are shifted from fixed-rate investments to floating-rate assets and inflation-linked bonds.

Shares and property usually perform well as inflation moves up from a negligible to a modest rate, but may not protect the real value of investors' capital should inflation moves from moderate to high.

In my view, it's time for investors to be building into their investments — particularly their superannuation savings — some protection against the prospective return of inflation, initially in the US and spreading out from there.

Don Stammer chairs QV Equities, is a director of IPE and is an adviser to the Third Link Growth Fund, Altius Asset Management, Philo Capital and Centric Wealth. The views are his alone.