# Ignore the spectre of inflation at your peril


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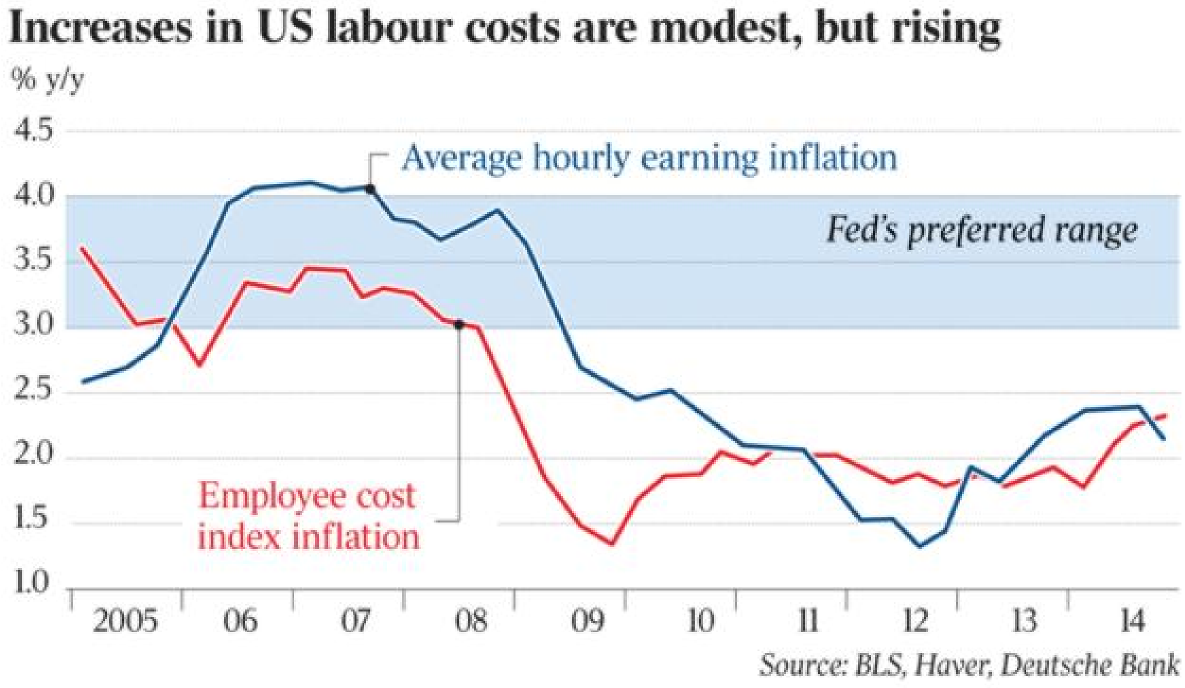


US labour costs. *Source:* TheAustralian

**HERE are the top three items now topping my "what to watch" list in investment markets.**

● Keeping a close look out for signs US inflation might soon reappear — because they will determine when the US cash rate is raised and because bond yields in the US are priced for near-zero inflation over the next couple of decades.

● Staying aware of prospects for property failures in China — because the prevailing view, most likely overdone, is that an imminent property slump will cause financial failures and recession in China.

● Reviewing Greece's ability to agree, and then deliver, a program for rescheduling its debts acceptable to its euro partners — because market sentiment has recently swung from fear of a break-up in the eurozone to confidence a deal will soon be agreed.

For now, I just want to focus on inflation. It is held to be almost non-existent at present, and for the next few months in most countries it will likely be depressed by the flow-on effects of cheap oil.

Even a small hint of prospective inflation in the US — where jobs are growing at the rate of a million every four months — would cause the Fed to raise its cash rate and bring about a likely sell-off in bonds around the world.

In my view — shaped, no doubt, by my having lived through a half-dozen or so cycles in inflation — investors who take their eyes off the risks of inflation leave themselves ill-prepared for the harm it does to investment plans and returns.

Recent record lows in bond yields in the US and most other countries reflect each of the bond purchases by major central banks under their programs of quantitative easing financed by printing money, the very low cash rates, and expectations on the part of many investors that inflation will be just about non-existent even in the long term.

A recent paper by members of the Deutsche Bank research team in New York is entitled, "Why do market views on inflation differ from the Fed's?"

It shows how low are expectations of inflation held by the Fed and (even more so) by the US bond market.

The Fed has a twin mandate: to maintain a high level of employment — now thought of as an unemployment rate of 5.5 per cent — and inflation at 2 per cent (it's undershooting this goal).

Each few months, the Fed releases the results of its survey showing the individual forecasts its senior people have for inflation, economic growth and the cash rate. (Names are not revealed.)

The most recent survey had the median forecast for US inflation running below the target rate in each of the next three years.

The report also looks at estimates for future inflation as implied in the pricing of bonds and as derived from surveys of investors.

It finds inflationary expectations in the US bond market "imply that the Fed will not be able to reach its 2 per cent inflation goal in the next five to 10 years".

The authors of the report see significant risks of inflation returning sooner than the Fed is forecasting — and much earlier than the bond market now anticipates.

They conclude: "While the overall economy may still be a year or more away from reaching full capacity and overheating, wage inflation appears already to be on an upward trend."

Even with the strong US dollar and low inflation in other countries, "a year from now, upward pressure on wages and prices should be noticeably more intense than they are today".

My worry is there could be a clear enough hint of inflation — in figures for labour costs — to cause the beginning of a cyclical sell-off in bonds and a noticeable wobble in sharemarkets.

Maybe, a recent half percentage jump in yields on 10-year US bonds — to a still-skinny 2.15 per cent — is an early sign of what's coming up by year's end.

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