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AMP CAPITAL

World economy – deflation, inflation or muddle through?

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Key points

- While the global economy has been 'muddling through' in the face of public debt problems over the past few years, this is still the most likely scenario going forward.
- Alternative scenarios involve a return to global recession and/or deflation or a surge in global inflation. Of these, inflation is judged to be the least likely.
- The implications for investment returns under the inflation or deflation scenarios are very different, but the 'muddle through' scenario would likely support reasonable returns from shares and growth assets.

Introduction

Recent falls in share markets and a plunge in bond yields suggests the world may be back in the "danger zone" the IMF and World Bank were referring to in September last year. This note looks at alternative scenarios going forward.

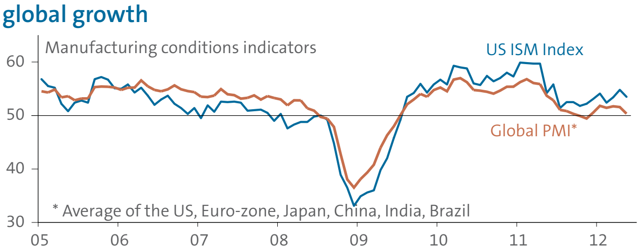
Risk off

From their highs earlier this year to recent lows global share markets have experienced a 12% fall. More significantly, government bond yields in the US, UK, Germany and Australia have fallen to record lows that provide no or little compensation for inflation and can only be justified if the world goes back into recession, experiences very weak growth and/or has a bout of extended price deflation. The triggers for recent market falls are well known:

- European debt problems have resurfaced in a big way, led by worries Greece will leave the euro and create contagion across Europe, Spanish banks needing to recapitalise, European economic data deteriorating and policy makers again arguing about what to do.
- Chinese economic growth indicators slowing further.
- US economic data suggesting its economy is going through another soft patch (as highlighted by weak employment growth in May).

These issues were covered in a recent note[1] and it's hard to say anything new, particularly regarding Europe. Right now global business conditions indicators have been slowing but are still a long way from the levels they collapsed to during the global financial crisis and at this point, are still consistent with moderate global growth. Although the fact they are still slowing obviously adds to concern, as illustrated in the next chart.

Global business conditions indicators (PMIs) point to moderate global growth



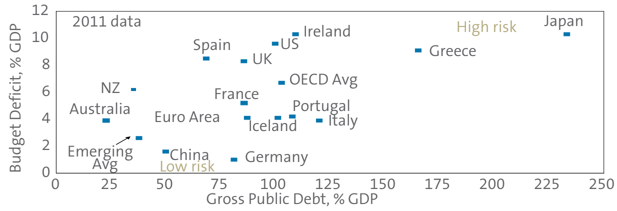
Source: Bloomberg, AMP Capital

1. See, "Europe, China, the US – the worry list for investors getting wider again", Oliver's Insights, May 2012

The problems in Europe are inherently solvable, involving some combination of debt forgiveness, bailouts, easy money and structural economic reforms. The broad parameters of what is immediately needed in Europe are well known – more austerity measures, using Eurozone bailout funds to recapitalise banks, providing a Europe-wide guarantee of bank deposits to stop bank runs, using the bailout funds or the European Central Bank (ECB) to reduce Italian and Spanish bond yields and ECB monetary easing. For various political and economic reasons, progress is slow and often sees things go to the brink before action occurs. Germany doesn't want to move too quickly lest it be seen as letting the troubled countries off the hook without them agreeing to longer term structural reforms.

At the same time, US and Japanese public debt problems have yet to be resolved with both having worse budget deficit and public debt ratios than Europe in aggregate.

Global public debt stats – US & Japan still have issues too



Source: OECD, IMF, Eurostat, AMP Capital

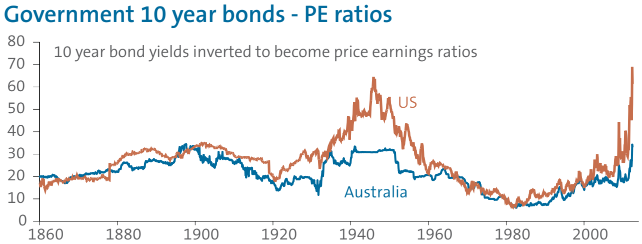
Deflation, inflation or muddle through

This naturally begs the question as to what the end game will be for advanced countries and hence, the global economy. While many perturbations are possible, essentially three scenarios prevail, these being: a blow-up resulting in extended weakness and deflation, inflation as countries inflate their way out of debt, or ongoing muddle through.

Deflation – This could occur via various causes. The Eurozone could fall into a deep recession via a disorderly Greek departure from the euro; banking crises could spread from Spain to Italy or in response to ongoing fiscal austerity and spread to the rest of the world via trade and financial linkages. Alternatively, the debt crisis could spread to the US and Japan, forcing them into aggressive fiscal austerity. Of course, such cases would assume that policy makers move too slowly or are powerless to stabilise conditions.

Bond markets are effectively factoring this in. Ten year bond yields in the US, UK, Germany and Australia have fallen to record lows, i.e. below those seen at times of depression, deflation and war. Another way of looking at this is to invert bond yields which effectively turn them into price to earnings (PE) ratios (see chart below). These are at record levels with Australian bonds on a PE of 33 times and US bonds trading at 61 times. Bubble territory? Buying bonds on such exorbitant PE multiples or record low yields only make sense fundamentally if extended deflation and/or poor growth is in prospect for a long time.

Government 10 year bonds - PE ratios



Source: Global Financial Data, AMP Capital

Inflation – The alternative scenario is that policy makers inflate their way out of public debt problems, intentionally or inadvertently, as very easy monetary conditions eventually lead to a surge in demand and inflationary pressures to which the authorities are too slow to reverse.

Of these two extreme scenarios, inflation is less likely as:

- There is no sign of it in countries that have run quantitative easing, e.g., the US, UK and Japan.
- There is a big difference between boosting narrow money (which results from quantitative easing) and broad money and credit (which depends on banks making more loans and can be inflationary) and we haven't seen the latter.
- It would take a big change in central bank mandates which target inflation of around 2% to allow serious inflation to take hold, i.e. sustained above 3%. For example, US Congress would not allow it as the Tea Party dislikes Bernanke, partly because they think he has already sown the seeds of inflation. This thinking has a big influence on the Republican Party.
- Finally, if global growth does move back above trend in the next few years it would be several years before excess world capacity is used up, causing higher inflation.

So overall, I would put a much higher weight on a deflationary type scenario than one of high inflation.

Muddle through – The last few years could be characterised by a muddle through scenario (with "can kicking" in Europe and monetary easing to help keep growth from collapsing). This has made economic sense, e.g. delaying any blow up in Greece to the point when bailout funds are stronger, should this occur. US economic policy also makes some sense – it is a bit like a patient that has a severe accident and is now in a coma. The US Federal Reserve is the drip keeping the patient alive until it can heal itself to the point where it can come out of the coma. And there is evidence of healing in the US (e.g., US private debt down, US housing bottoming, US manufacturing renaissance, etc.) but it was never to be the case that monetary policy would cure the economy.

The muddle through scenario in relation to Europe assumes that the periodic cycle of revolt, response and respite continues but with each cycle getting closer to what Europe needs (bailouts and easier money) and what Germany wants in return (centralised fiscal union, banking controls and economic reforms in peripheral countries) and hence, an eventual exit from the problem. Europe is further down this path than at the start of 2010 when there was no fiscal compact or even a bailout fund.

Around this muddle through scenario, investor sentiment has swung several times over the past few years between worries about inflation and deflation scenarios.

- During 2009 and into 2010 inflation fears started to surface with warnings of US hyperinflation;
- Around mid-2010 this was replaced by double-dip and deflation worries as share markets fell 15%;
- From late 2010 and into 2011 inflation fears returned, following QE2 in the US and talk of currency wars;
- During mid to late 2011 deflation and double-dip fears returned with 20% falls in share markets;
- Late 2011 to April this year saw a return to optimism but may not hold long enough for inflation worries to escalate.

Now we are back to worrying about a return to global recession and deflation. Each of the bouts of recession/deflation worries has been ended by policy action and I suspect we will see the same this time around. China is already moving, having started to cut interest rates but in Europe it's a question of how long this will take. Too much is at stake politically to let the euro collapse. Policy direction appears to be heading towards 'more Europe' in return for more bailout support from Germany. As such, the muddle through scenario would seem most likely. I would give it about a 65% probability as against 35% for the deflation scenario.

Implications for asset returns?

A continuation of the muddle through scenario would likely offer reasonable gains in share markets and growth assets over time (i.e. high single digits) given cheap valuations and it wouldn't take much to outperform bond returns.

The inflation and deflation scenarios would mean radically different outcomes for asset returns. If we break down into global recession/deflation, cash and sovereign bonds (in low debt countries) would be the place to be. But sovereign bonds would be tricky in this scenario given likely concerns of spiralling public debt in countries like the US which already have high public debt levels. Japanese bonds have done well despite deflation there, but the reasons are probably specific to Japan. Australian bonds might be seen as low risk given low public debt, but what if global deflation adversely affects China causing a collapse in commodity demand and Australian exports, resulting in rising unemployment, falling house prices and bank problems? Perhaps Asian sovereign bonds would be the place to be under a global deflation scenario, given the low starting point for public debt levels and less risk of economic collapse.

Alternatively, if inflation really takes off:

- Sovereign bonds would have to be avoided as yields will back-up causing sizeable capital losses;
- Corporate bonds might see spreads narrow but would be hit by the back-up in sovereign bond yields;
- Shares will benefit from stronger earnings growth but the negative revaluation effect of higher bond yields on PE multiples will likely dominate (this would be a reverse of 1980s and 1990s bull market in shares that was in part driven by falling bond yields as inflation fell);
- Real assets such as property and infrastructure will likely fare better as their yields didn't come down as much as for shares through the shift from high to low inflation; and
- Commodities will probably do well and gold will surge as this scenario is exactly what the gold bugs have been dreaming about for the last decade.

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