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Focus Article

An old risk awaits offstage

Trade tensions aren't the only worry. A surge in inflation pressures could upset the economic/investment apple cart.

Jim Allworth

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All values in U.S. dollars and priced as of March 29, 2018, market close, unless otherwise noted.

Wealth Management

Focus article

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There are more than trade tensions to worry about. A surge in price pressures—not in anyone's forecast, including our own or the Fed's—could upset the economic/investment apple cart. Two conditions that could push inflation uncomfortably higher are present simultaneously for the first time in a decade. Lean against developing inflation risks.

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Leaving politics and potential trade wars aside for the moment, an eerie calm has descended on the economic and investment backdrop:

- All the developed economies are growing at solid, if unspectacular rates, as is China and much of Asia. Russia and Brazil have pulled out of deep downturns.
- Purchasing Managers' Indexes (measures of economic activity) are at elevated levels pretty well everywhere, except perhaps China. Forward-looking indicators suggest industrial output will continue to grow.
- Unemployment rates continue to fall everywhere. Businesses in the U.S., Canada, and Japan cite difficulty in attracting and retaining qualified employees as a challenging business constraint. Wages are growing and consumers are confident.
- Corporate profits are strong, while upbeat management guidance points to continued growth in revenues and earnings through 2019.
- Central banks remain mostly accommodative, while commercial banks are out looking for creditworthy businesses and individuals to whom to lend.

What could disturb this happy, constructive equilibrium? In our view, something that is least expected—a sustained surge in inflation rates—would substantially worsen the global economic and investment outlook.

Possible change of trend

Source - RBC Wealth Management, U.S. Federal Reserve; data through Feb. 2018

An inflation surprise would push interest rates higher and alter the outlook for stocks, in our opinion.

On the policy front, this would force central banks to tighten faster than currently planned. Most central banks in the developed economies have a core inflation target of 2.0%. In all those countries inflation has been gradually picking up but remains below that threshold. After trying to avoid slipping into deflation for several years, most central bankers would breathe a sigh of relief if inflation were to move back up into a more "normal" zone.

But if it looked like inflation was headed toward 3%, asset markets might not wait for the Federal Reserve or the European Central Bank to make up their minds. The ultralow bond yields of the past several years have persisted because of the consistently low rate of inflation as well as the assurances of monetary policymakers that any move to "normalise" monetary conditions would be undertaken gradually and patiently. Unexpectedly strong inflation rates would call both presumptions into question.

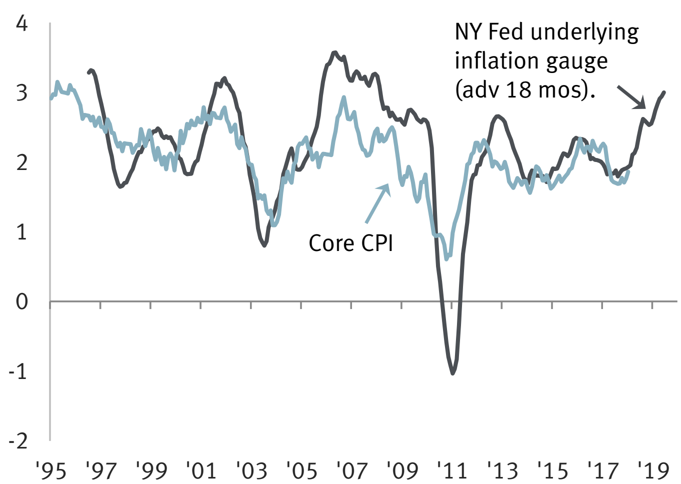
Bond investors typically demand a coupon rate well above the prevailing rate of inflation to protect against higher-than-expected inflation over the life of the bond. Conviction that inflation rates were going to stay low has persuaded bond investors in recent years to accept an unusually low cushion of such protection. Upsetting the apple cart of inflation expectations, were it to occur, might result in bond yields moving up by more than just the increase in the inflation rate.

Equity prices, for their part, would probably undergo some recalibration too. Rising corporate bond yields often act to bring price-to-earnings (P/E) multiples down, while a faster pace of monetary tightening raises risks of recession, bringing closer the prospect of an eventual decline in corporate profits and an accompanying bear market for equities.

Are there reasons to be concerned?

Let us say right here that a damaging surge in inflation is not in our forecasts for any of the developed economies or the emerging economies. We are looking for moderately higher inflation in 2018, with a little more to come in 2019.

Indications of higher inflation to come



History suggests the inflation rate should be moving higher this year and next.

Source - RBC Wealth Management, U.S. Federal Reserve Bank of New York

An old risk waits offstage

That said, there is at least one leading indicator that leaves open the possibility this year's widely expected gradual increase in inflation rates could be somewhat greater than forecast, with possibly more to come in 2019. The Underlying Inflation Gauge (UIG) published monthly and calculated by the New York Federal Reserve (see chart on previous page) has done a good job of flagging changes in the rate of growth of the core Consumer Price Index in the U.S. 18 months or so ahead of time. The UIG has been in an uptrend for 22 months, suggesting the inflation rate should be moving higher through this year and well into next.

Pre-conditions for higher inflation are present.

Two factors looked at together also suggest there is a risk of underestimating inflation over the next couple of years. The old monetarist dictum states inflation is the result of "too much money chasing too few goods." Arguably there is too much money and has been ever since central banks adopted aggressively accommodative policies in the wake of the Great Recession. In the intervening nine years money supply in the biggest economies has grown appreciably faster than GDP.

Too much money

Since Q3 2008	U.S.	Eurozone	Japan
Growth in GDP	33.1%	17.5%	6.3%
Growth in money supply	76.3%	42.8%	34.4%

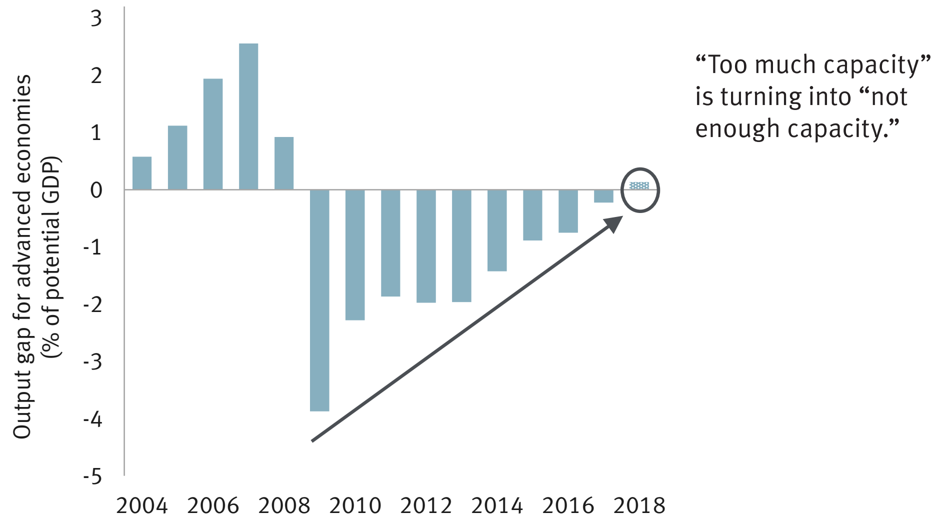
Money supply growth has outstripped GDP growth.

Source - RBC Wealth Management, U.S. Federal Reserve

This rapid growth of money supply concerned many observers who expected an inevitably damaging bout of inflation. But that excessive inflation never arrived. Just the opposite: deflation has been a preoccupying worry of central banks until very recently. One explanation has it that the "too few goods" part has been missing. There has been a great deal of excess capacity available in the developed economies even as China and much of emerging Asia were adding substantial new productive capability. This has kept prices of many goods subdued or even declining despite the growth in the money supply.

But today, fixed asset investment in China has slowed considerably while the government actively tries to shutter excess capacity in several basic industries. Meanwhile, the so-called "output gap" has closed in the developed world, with "excess capacity" turning into "not enough capacity" in several countries, including the U.S. (see chart on following page). So, one has to acknowledge the combined conditions of *too much money chasing too few goods* may be increasingly operative over the next couple of years and for the first time in a decade.

Economic slack finally gone in the developed world



Note: International Monetary Fund (IMF) estimate for 2018
Source - IMF, Haver Analytics, RBC Global Asset Management

We think the appropriate stance for most investors is one that leans against developing inflation risks.

Lean against risk

We think the appropriate stance for most investors is one that leans against developing inflation risks. We were already forecasting some increased inflation for the coming year. It's noteworthy that the Fed has recently pushed its own core inflation target to 2.1% for 2019, above its long-term target of 2.0% for the first time in years. Both our forecast and the Fed's fall a long way short of a damaging surge in price pressures.

That said, higher inflation than anyone is expecting would pose a significant risk to an investment portfolio. In a world where the output gap is in danger of closing for the first time in a decade and where there will continue to be excess money sitting in global bank accounts for some time to come, there is a greater probability that inflation expectations could undergo an upward shift that markets have not yet factored in.

Such a shift would hold ramifications for:

- The pace and eventual extent of central bank tightening;
- The spread between market interest rates and the inflation rate;
- The spread between corporate bond yields and government yields;
- The valuation (P/E ratio) of the equity markets; and
- The appropriate sector composition of equity portfolios.

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