



Inflation and deflation tug of war – what this means for investors

The global economy is responding to a tug of war between the pressures of inflation and deflation. AXA's Chief Investment Officer Mark Dutton looks at why credit squeezes are deflationary, policy measures to reflate the economy and what this means for investors.

In brief

- In the current environment, near term deflationary pressures are greater than inflationary pressures.
- Over the longer term, recent policy measures may overshoot and cause inflation to rise above desired levels.
- Investors holding a high proportion of government bonds could be caught out when an inflationary environment re-emerges.

Deflationary forces at work

The credit crisis has caused the global economy to change so rapidly that concerns have now risen about the risk of wide-spread deflation - a situation typically defined as a persistent decline in general price levels. While it might be tempting to think that falling prices could be good for consumers, deflation on a large scale would be a horrendous outcome.

When deflation grips early in a recovery cycle, it can reduce the effectiveness of policy measures to kick start the economy. This is particularly the case for monetary policy because it becomes impossible to drive real interest rates below zero.

Sustained deflation creates a destructive cycle for which there is no automatic correction process. It causes the cost of debt servicing to increase in real terms, reduces pricing power for companies and drives asset values lower. This process can bankrupt businesses or even countries.

Credit squeezes create deflationary conditions. Credit is the engine of the economy and when it seizes, economic growth, commodity and asset prices plummet. Deflationary forces are unleashed by the subsequent collapse in global demand, de-leveraging (unwinding of unsustainable debt), rising unemployment and pressure to reduce unwanted inventories.

The G7 nations – US, Canada, UK, France, Italy, Germany and Japan – are showing signs of deflation. Inflation across the G7 countries has decreased from 1.2 per cent in 2008 to negative 0.2 per cent in 2009. While the US, Canada, Germany and Japan account for most of this decline, inflation levels for the other G7 countries are well below minimum target levels, which most central banks see as inflation rates of 1 to 3 per cent.

Inflation declining in G7 nations

| | 2008 | 2009 |
|---------|-------|--------|
| US | 0.77% | -0.15% |
| Canada | 1.93% | -0.17% |
| France | 1.19% | 0.45% |
| Germany | 1.13% | -0.95% |
| Italy | 3.36% | 0.72% |
| UK | 3.88% | 0.80% |
| Japan | 0.39% | -1.34% |

Source: International Monetary Fund. Inflation, end of period consumer prices, annual per cent change, April 2009

Inflationary pressures likely to rise over the longer term

Governments and Central Banks across the globe have implemented multiple policy measures to revive credit markets, stimulate an economic recovery and reduce the threat of deflation. These measures include significant reductions in interest rates, injections of large amounts of liquidity into the system through quantitative easing, in conjunction with fiscal stimulus packages amounting to 1.7 per cent of global Gross Domestic Product (GDP).

Point of view

Mark Dutton, Chief Investment Officer – Australia & NZ, AXA



The sheer magnitude of these initiatives means that sustained deflation is likely to be avoided in the G7 countries, with the exception of Japan.¹ But in the bid to reflate the economy, there is some danger that stimulus measures will overshoot, and cause inflation to rise when credit markets return to 'normal'.

What this means for investors

Deflation is bad news for equity investments. In this environment it becomes difficult for profits to be sustained because companies lose pricing power, demand falls, and debt levels increase in real terms. While most sectors would be adversely affected by deflation, companies with low levels of debt that are likely to benefit from policy measures to reflate the economy would become more in favour.

An outlook of sustained deflation would mean that assets with fixed nominal yields, such as bonds, or other fixed rate assets appear more attractive than shares. Over the past six months, concerns about deflation, coupled with risk aversion, has driven investors into the Government bond market, forcing prices higher and therefore yields lower.

However, as we have previously argued, government bonds are not as safe as they appear. The current 3.3 per cent yield on 10 year US government bonds is unusually low and unlikely to be sustained in the long term.

Large issuance of government bonds to fund stimulus measures in major global economies are adding to the pressure for yields to rise. When yields reach a more 'normal' level of around 6 per cent, the loss to investors could be more than 15 per cent.

Policy makers have started to recognise that stimulus measures have swung the future risk from deflation to higher inflation. Consequently, we are already seeing an increase in the demand for inflation-linked bonds. For example, Chinese authorities have recently asked the US government to increase issuance of inflation indexed US treasury bonds, of which China hold 24 per cent of current issuance. This suggests that Chinese authorities expect long-term inflation to trend up and believe pricing for treasuries is not sustainable.

The global credit crisis has shown us that our economic environment can change remarkably quickly. The unprecedented magnitude of current global stimulus is likely to prevent an entrenched deflationary environment. But there is the danger that these measures could overshoot and inflation could emerge more quickly than anticipated. These trends highlight the importance for investors to maintain exposure in growth assets, such as equities, to generate a real return above inflation over the longer-term.

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¹ The Bank of Japan has indicated that it expects deep and sustained deflation in the coming years.

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