

January 30, 2009

## Downunder Daily

### Inflated Concerns

**Will last year's deflation fright morph into this year's inflation scare?** The rising gold price hints that some are worried. The fact that investors (and policymakers) were focused on inflation a year ago but are now focused on deflation warns that perceptions can quickly reverse. I'm not worried about inflation on a 2-3 year view. Tail risk remains fatter for deflation than for inflation.

The reason is straightforward: The world is in recession, and recessions crunch inflation. Recessions even reduced inflation in the stagflationary 1970s. That fall was against a backdrop of entrenched inflation expectations and more rigid, less open economies.

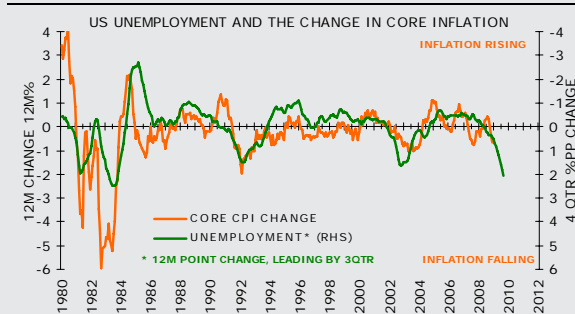
Inflation is now falling. The spectacular about-face in headline inflation rates is due to the as-spectacular turnaround in commodity prices, particularly oil. Core rates are likely to fall this year.

Exhibit 1 shows how the rise and fall in unemployment correlates with the change in core inflation in the US. (The unemployment line is inverted, so the line falls as unemployment rises.) Likewise, Exhibit 2 shows how real GDP growth leads the rise or fall in core inflation. Our US team's GDP forecast points to a substantial fall in inflation through this year.

One factor will limit the dive in headline inflation: the likely moderation in commodity price declines. This is not a sophisticated argument: In fact, it's the reverse of the year-ago arithmetic when rising energy prices were adding 2½ percentage points to headline CPI in the US. The point then was that headline inflation would fall by 2½% when energy prices stopped rising, even if prices remained at elevated levels. Now, by coincidence, falling energy prices are subtracting 2½% from headline CPI (Exhibit 3). So the reverse is true: If oil stays where it is, headline inflation will accelerate by 2½% even if energy prices remain at low levels.

Exhibit 1

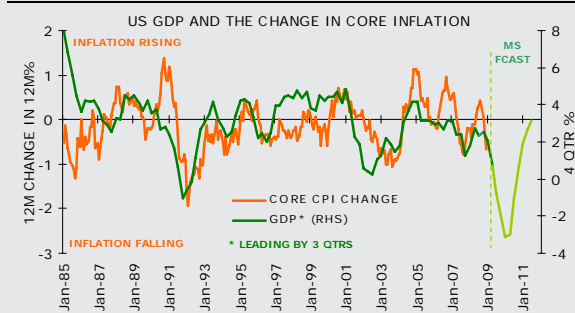
#### Weak Growth ...



Source: BEA, BLS; Morgan Stanley Research

Exhibit 2

#### ...Crunches Inflation



Source: BEA, BLS, Richard Berner and David Greenlaw; Morgan Stanley Research

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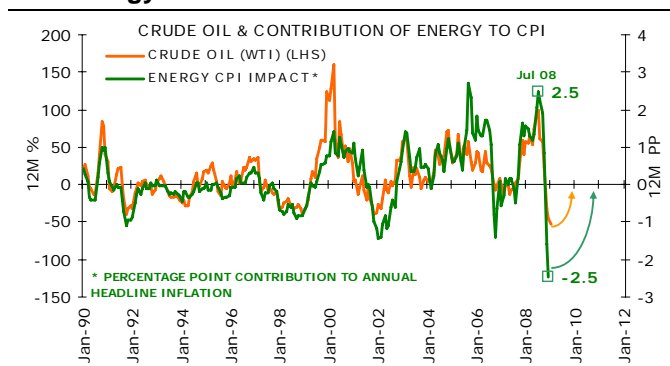
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With headline inflation rates now low (in some cases, negative) and the globe facing a deep recession, I think the risks of deflation greatly outweigh the risk of inflation on a medium-term view. This is not news to markets: Breakeven inflation rates have plummeted over the past six months (Exhibit 4). At its low, the 10-year breakeven inflation rate in the US was zero. That is, the market expected a decade of flat prices. While the risk of deflation may outweigh that of inflation, ten years of zero inflation in the US seems to me far too pessimistic (and the market is now reconsidering).

Exhibit 3

### The Energy Influence Will Moderate

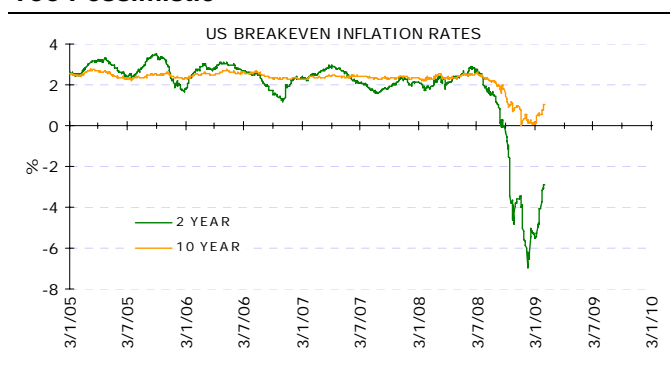


Source: DataStream, BLS; Morgan Stanley Research

Some investors are worried about inflation because of the sharp acceleration in money supply growth. Inflation is always and everywhere a monetary phenomenon, right? A few points on this:

Exhibit 4

### Too Pessimistic



Source: Bloomberg; Morgan Stanley Research

First, policymakers' priority now is to revive growth, not manage inflation. Pumping financial systems full of money is part of their strategy, along with lowering interest rates and deploying fiscal stimulus. But inflation follows growth.

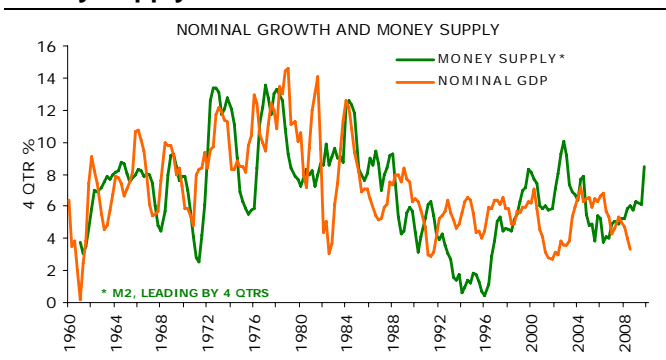
Investors will be warned about a possible inflation problem, because the recovery will be well under way. Indeed, as this recession will likely end with substantial amounts of excess capacity, the expansion will be able to run on for a long time before inflation is a problem.

Second, there is nothing 'special' about the stimulus generated by expanding money supply. Just as fiscal expansion won't cause inflation until real growth has revived, nor will monetary-led expansion. Put another way, money supply expansion will not cause the economy to leapfrog from economic contraction to rising inflation without first promoting a recovery in real activity.

Third, as I've argued before, I'm not sure that money supply expansion will provide its usual stimulus in this cycle. The link between money supply and nominal growth has never been perfect (Exhibit 5). Just as growth was sustainably higher than money supply in the early 1990s, we may see a period where nominal GDP growth is slower than money supply growth. (The velocity of money will decline.)

Exhibit 5

### Money Supply and Nominal Inflation



Source: Federal Reserve; Morgan Stanley Research

Finally, at some stage there will be recovery. Possibly this year, more likely in 2010, or possibly later. If policymakers miscalculate the withdrawal of their stimulatory policies in the recovery phase, then, yes, we could face an inflation problem. The risk of such a miscalculation is probably higher than usual because policymakers have little or no practical or historical experience adjusting the policy levers they have used in this cycle. But that inflation risk will exist only after the expansion is well developed. That still seems likely to be several years away; too far away to trade, in my view.

*I'm marketing in the US for the next fortnight; back 16 February. GM*



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