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Inflation vs. Deflation (U.S. vs. Europe/Japan)

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As part of this year's investment symposium, I spoke at a session: "Inflation vs. Deflation (U.S. vs. Europe/Japan)" which centered on whether the recent short-term drop in oil prices and USD strength is only temporarily preventing U.S. inflation from rising, or if Europe and Japan could instead drag the U.S. into a deflationary spiral.

I was very fortunate to be joined by two esteemed speakers from Vanguard: Senior Portfolio Manager, Gemma Wright-Casparius, and Investment Analyst and Strategist, Andrew Patterson. I thought that it might be of interest to report on some of the key items mentioned as well as my conclusions based on the discussion.

GLOBAL ECONOMY

Over the last few decades, global economies have become more integrated, and central banks more consistent in their actions—accordingly, there has been a long-term convergence of global inflation rates—for the most part, lower. However, in efforts to drive inflation and inflation expectations nearer their stated targets, global monetary policies in developed markets are beginning to diverge. In the current environment, disinflation and deflation remain global risks, but more so in those regions that have implemented more aggressive easing measures, namely Japan and the EuroZone.

Even within the EU, the North is experiencing higher core inflation than Southern Europe—a reflection of their relative economic performance and a likely by-product of aggressive internal devaluations (austerity and structural policies) in the south. In the United States and Britain, the time for beginning to once again raise policy rates is approaching.

Recent comparisons between different economies has been distorted by the recent drop in oil prices. Core inflation, which strips out energy and food prices, has been more consistent globally. More importantly, the oil price drop is likely a net positive for the world—and the resultant economic stimulation could ultimately spur wage inflation.

The overall conclusion was that the recovering U.S. economy will create wage pressures, and thus higher inflation in due course. This is less clearly the case in Europe, where the recovering is being slowed due to sovereign crises in the southern countries; and Japan where the verdict is still out on whether Abenomics is going to succeed.

INFLATION MARKETS

Global inflation-linked bond issuance continues to grow, in both developed and emerging economies—with the U.S. being the largest market. In addition, there is an active market in Inflation derivatives—which tends to use the same measure of CPI as the corresponding bond markets.

However, when comparing countries, it is important to factor in differences in both weightings and seasonal patterns of domestic consumer inflation.

It should be noted that asset performance depends on both inflation and real growth.

While investors often assume the market-implied expected inflation level as the inflation rate of indifference between Nominal and Real rate (e.g., Treasury Yield less Real Yield of similar maturity TIPS issue), known as the breakeven Inflation rate. The reality is that this measure also encompasses an inflation risk premium and a liquidity premium. It tends to be difficult to disentangle these factors in day-to-day market moves.

Nevertheless, the key market drivers are:

- Macroeconomic events;
- Monetary policy;
- Actual inflation (i.e., wages); and
- Unanticipated changes to inflation expectations (due to commodities, currency exchange rates, shifts in risky assets, Fed balance sheet, reported inflation surprises).

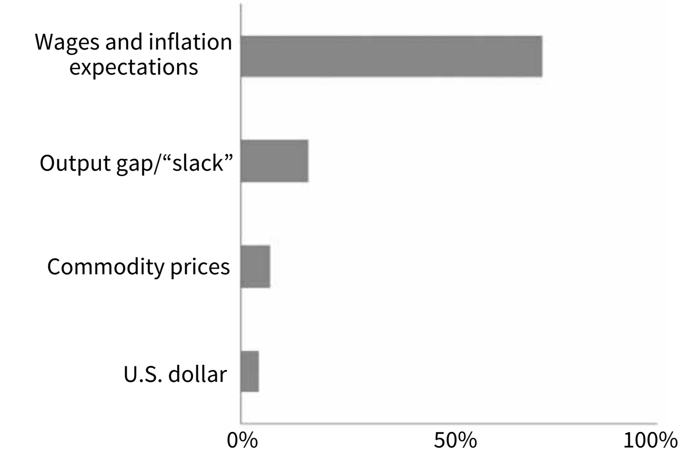
CONTINUED ON PAGE 36

Secular Shift

Real Growth	Low/Falling	High/Rising
High/Rising	Best: Stocks Mixed: Commodities and nominal bonds Worst: TIPS	Best: Commodities Mixed: Stocks and TIPS Worst: Nominal bonds
Low/Falling	Best: Nominal bonds Mixed: Stocks and TIPS Worst: Commodities	Best: TIPS Mixed: Commodities and nominal bonds Worst: Stocks

Source: PIMCO Institute, Presentation on "An introduction to Inflation-Related Investing" by Bob Greer, September 24, 2010

Decomposition of variance of U.S. core inflation, 1983-2013



Note: Chart based on inflation-variance decomposition described in Vanguard research (Davis, 2007).

Sources: Vanguard, based on data from U.S. Bureau of Labor Statistics, Federal Reserve Board, Bridge/Commodity Research Bureau, and Federal Reserve Bank of Philadelphia.

Breakeven Inflation is cyclic, and we should anticipated an upward move in a growing economy.

Financial markets are increasingly interconnected, and global capital flows are strengthening correlations. Notwithstanding this, ultimately inflation-linked bond markets reflect domestic economies.

PARTICIPATION BY INSURANCE COMPANIES AND PENSION FUNDS

Insurance companies and Pension funds are large players in the inflation market—either for purposes of asset-liability management, or to benefit from diversification.

There are annuity and long-term care products that have payments directly linked to CPI. In addition, P&C policy claims inflation has been highly correlated with large moves in CPI. As a result, not only have insurance companies invested in Iinflation-linked bonds, but there are examples of large hedging programs using inflation derivatives—both inflation swaps, and inflation options.

On an absolute basis, the U.S. is the largest inflation-linked market; however, countries like the U.K. and Canada, have much longer average durations of outstanding bonds—this reflects even stronger participation by pension funds in these markets on a relative basis. Often the participation is influenced by regulations and taxes. This is true for a number of countries in continental Europe as well, such as the Netherlands and in Scandinavia. In Japan, the issuance of inflation-linked bonds initially faltered due to a lack of protection against deflation in the design of these securities. However, more recent inflation-linked bonds have incorporated a deflation floor, and there has been much greater participation in these issues.

IN CONCLUSION

The underlying U.S. economic recovery has not yet been reflected in reported inflation due to the drop in oil prices, U.S. dollar strength, and remaining slack in the labor market. However, all of these factors should pass, and we may witness wage inflation that will translate into increases in consumer prices. This will further translate into higher market inflation expectations as reflected in breakeven inflation; as well as greater demand for inflation protection, including within insurance contracts and retirement savings.

The session presentations are available on the conference website (investmentsymposium.org). If you have any questions or thoughts, please feel free to contact me. ■

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