Inflation Deflation

In my post of 11 Aug 2008, I said that recession was the greater concern over inflation, at a time when US CPI was 5% and PPI 14%. Today there are fears of deflation. Looking forward, the risk to inflation is on the upside.

In late 2006, the oil price was in the range 60 – 70 USD which is regarded by Purvin and Gertz an energy consultancy as the market clearing price based on demand and supply from industry, that is ex financial speculation for 2009. The gap between headline CPI and core CPI was running at about 2% at the time. Assuming now that economic growth slows further and that we end up in a late 2002 situation where US Core CPI was at about 1%. Energy prices back at 60 – 70 USD could add another 1.5 – 2% to inflation taking it to 3 -3.5%. All this assumes that the US and other developed economies, which are mostly those running budget deficits, do not debase their currencies as they try to fund further bail outs and fiscal reflationary policies. The risk, I believe, is that in 12 months time, an expansionary China and India, competing for resources, and being inefficient users of resources, bid up the price of cyclical commodities and food, and drives prices to the point where inflation begins to pick up in the developed world.

With the debasing of currencies, this could result in CPI in the 5-6% range. Not disastrously high, but not disinflationary either. In fact, it might be a comfortable range to be in, supporting long term bond yields and maintaining the term structure.

More interestingly, investors who were happy to sit on cash will find that strategy eroded by inflation, and will at the least have to find inflation hedges, mostly found in risky assets.

Now, if countries like the US start printing money, all bets are off. Inflation then becomes a case of a shrinking yardstick (purchasing power of money), and could be unbounded.