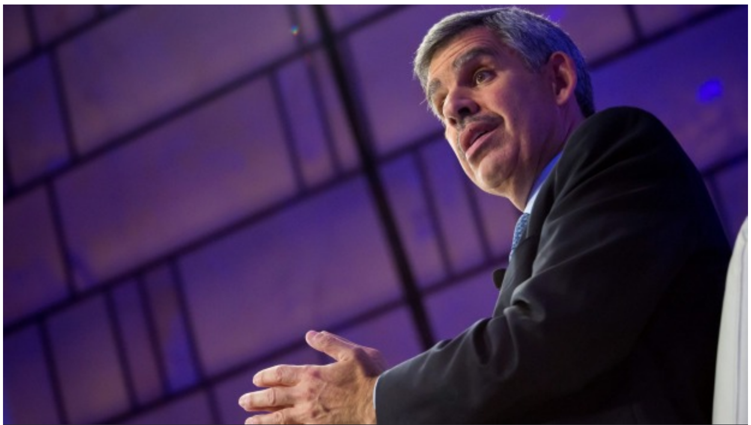
OPINION | Nov 15 2017 at 9:46 AM | Updated 1 hr ago

Investor complacency at risk as green shoots of inflation emerge



'A loose monetary approach may have overly repressed financial volatility ... and encouraged too much risk-taking by non-banks,' says Mohamed El-Erian, who is a contender for a Federal Reserve post. **Michael Nagle**

by Karen Maley

Are we nearing one of those major, nerve-racking turning points in financial markets when asset prices swing wildly as investors are forced to re-examine the fundamental assumptions of their investment strategy?

The fear that US inflation – long assumed to be comatose – could finally be showing signs of life sent shivers down investors' spines overnight. The concerns were triggered by the release of figures that showed US producer prices rose way more than expected in October, resulting in the biggest annual increase in wholesale inflation in more than five and a half years.

The US producer price index (PPI) increased 0.4 per cent in October, wrong-footing most economists who had been tipping a 0.1 per cent rise. The stronger inflation rise – which lifted the year-on-year increase in the US PPI to 2.8 per cent – reflected a big jump in the cost of services, as well as higher prices for pharmaceutical and food prices.

Although the PPI is not the primary measure of US inflation, October's strong reading suggests that price pressures are building in the US production pipeline, and that it could be just a matter of time before these are reflected in higher US consumer prices.

This would confirm a key prediction of Tim Toohey, the highly regarded former Goldman Sachs economist who joined Ellerston Capital's new global macro fund this year.

In a note published in September, Toohey looked at what had been weighing on US inflation this year – including the flow-on effect of last year's US dollar strength, the stabilisation of oil prices, weak growth in rents and falling public administered prices – and concluded that many of these factors were likely to dissipate, or even change direction, in coming months.

"From our analysis, the evidence clearly points to a relatively sharp acceleration in inflationary pressures in coming months," Toohey said, adding that the annual rate of

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This pick-up in inflation, he said, would embolden the Fed to deliver on its proposed interest rate hikes – the US central bank has pencilled in one interest rate hike this year, followed by three rate rises next year.

More, importantly, he warned that "it will cause markets to seriously question whether the Fed is behind the curve".

Fears that the US central bank could be forced to raise rates more rapidly in response to a sudden, unexpected break-out in inflation will force investors to reassess their investment strategies, which have been predicated on the assumption of gradual, well-telegraphed US rate rises.

Even worse, this rebound in inflationary pressures comes at a time when the world's major central banks are weaning markets off exceptional monetary stimulus. The US Federal Reserve has already begun the process of shrinking its balance sheet, while the European Central Bank has announced plans to halve its monthly bond purchases from January.

As Toohey pointed out, "for financial markets, the combination of a sharp re-acceleration in inflation coinciding with the commencement of quantitative tapering (QT) and robust economic growth momentum leaves developed market bonds, the 'yield trade', risk parity strategies and minimum volatility strategies highly vulnerable".

Dovish stance

The outlook for investors has been further clouded by reports that the White House is considering former PIMCO chief executive, Mohamed El-Erian for the position of vice-chairman of the Fed.

This month, investors were relieved after Donald Trump nominated Fed governor Jerome "Jay" Powell to succeed Janet Yellen when her term as Fed chair expires early next year. Powell is generally viewed as likely to continue Yellen's relatively dovish monetary stance.

But this complacency could be shaken if El-Erian, who was a former deputy director of the International Monetary Fund, is appointed as his deputy. That's because the widely respected El-Erian has voiced concerns that excessively low interest rates are causing dangerous distortions in financial markets.

"Already, economies on both sides of the Atlantic must contend with the risk that a loose monetary approach may have overly repressed financial volatility, excessively boosted a range of asset prices beyond what is warranted by economic fundamentals, and encouraged too much risk-taking by non-banks", he warned in his *Bloomberg* column in August.

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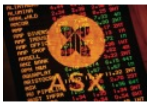
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