

# Global Inflation Outlook 2010: An Inflation Odyssey

JANUARY 2010

FOR PROFESSIONAL INVESTORS ONLY



**Brian Weinstein** – Managing Director, is a co-head of the Global/Non-Dollar Portfolio Team within BlackRock's Fixed Income Portfolio Management Group. Brian moved to his current role in the Portfolio Management Group in 2002. He joined BlackRock in 2000 as an analyst in the Portfolio Analytics Group after spending several summers with BlackRock as an intern. Brian earned a BA degree in history from the University of Pennsylvania in 2000.



**Adam Bowman** – Director, is a member of the US Rates Investment Team within BlackRock's Fixed Income Portfolio Management Group. Prior to joining BlackRock in 2005, Adam spent two years as an Analyst with Macroeconomic Advisers focusing on the analysis of the strategic link between economic outlook and the policy actions of the Federal Reserve. Adam began his career at the Center for Strategic and International Studies as a Research Assistant to Dr. Laurence Meyer, a former Federal Reserve Governor and principal of Monetary Policy Insights. Adam earned a BA degree, with honors, in economics from Miami University in 2003.

As of 30 September 2009, Brian Weinstein and Adam Bowman oversee inflation-linked bond strategies totalling US\$18.7bn in segregated mandates and mutual funds.

January provides an excellent opportunity to reflect on the events of the previous year and begin to look forward to the coming year. The exercise is particularly relevant this year because of the extraordinary events that have taken place in the financial markets and the extreme uncertainty that clouds the outlook for them over the next several years. Inflation is no exception and we will focus this month's Global Inflation Outlook on a review of the past year's events and the factors that will importantly shape the inflation outlook over the coming years.

How the world has changed! In December of 2008, the global inflation markets were in the midst of an unprecedented correction, which saw peak-to-trough declines in the total return of US, UK, European and Japanese inflation markets of about -13%, -14%, -6% and -22% respectively<sup>1</sup>. Fundamental developments explain part of the decline in inflation markets. The sell-off in crude oil of nearly -70% meant that retail energy prices would decline markedly. Inflation markets had been priced for near-term increases in consumer price indices (CPIs) of nearly 3.5%, but that inflation rate could not be realised with the decline in energy prices and therefore the market had to re-price downward. The financial crisis certainly exacerbated the sell-off in inflation markets too, because many investors

# BLACKROCK

were forced to make margin calls or shrink balance sheet by selling whatever was liquid and many investors chose to sell relatively-liquid inflation bonds. By the end of December 2008, the inflation markets were priced for outright deflation in 2009 and 2010, and thereafter very low inflation for as far as the eye could see.

The advent of 2009 saw a near-complete reversal of the price action witnessed in 2008. Many institutional and retail investors viewed the near-term deflation priced into the market as an unlikely outcome – especially in light of the efforts of the fiscal and monetary authorities to stimulate aggregate demand – and allocated capital to the sector. Other investors simply thought that the financial crisis raised long-term inflation risk and allocated capital out of that concern. Whatever the reason, the end result was an explosive rally in breakeven inflation. Breakeven inflation widened nearly nonstop from January 2009 until December 2009; by the start of 2010 not only was the deflation outcome fully priced out, but the market also began to price in inflation of 1% in 2010, 2% inflation in 2011 and 2.5% to 3.0% inflation for every year thereafter. Of course the current market pricing begs the question of whether today's market expectations for the path of inflation are reasonable – especially over the next two years.

Perhaps the most accepted framework of inflation dynamics is what is known as the Expectations Augmented Phillips Curve or what we will call the EAPC for ease of writing. Essentially, the EAPC says that today's inflation rate is a product of yesterday's inflation rate, cyclical forces, inflation expectations and price shocks. The EAPC framework is elegant for its intuitiveness and useful for its simplicity. Inflation tends to be quite persistent over time and the EAPC's inclusion of yesterday's inflation rate is one way to acknowledge this fact. The inclusion of a cyclical term, meanwhile, allows for the supply and demand for goods and services to affect pricing power. Inflation expectations are included in the EAPC because they affect consumer and business behaviour, both from a demand and pricing prospective. Finally, shocks are allowed to affect inflation because relative price shifts can sometimes powerfully affect underlying inflation – for example, if the price of oil were to double, the prices of many goods and services would also increase because oil plays such an important role in making things or in transporting them.

If one spends a minute thinking about those terms in the context of today, the inflation outlook would seem quite benign. Inflation has been slowing for the past year and, because inflation is fairly persistent in its rate of change, that bodes well for the coming year. Inflation expectations as measured by both surveys and market expectations remain relatively low and stable, which also portends to low inflation. Finally, unemployment rates in much of the industrialised world have risen precipitously over the past year and are lingering near the highest levels in the past 25 years or so. The EAPC frame-

<sup>1</sup> All returns are in local currency terms and are calculated from the family of Barclay's Global Inflation Indices.

work would suggest that such a high rate of unemployment would cause a large deceleration in inflation - especially if unemployment rates were to remain high for a long time. Indeed, many respectable economists hinge their forecasts for low rates of underlying inflation in the developed world in 2010 and 2011 on high unemployment rates and what the EAPC says they imply for inflation.

In our view, it would be a mistake to conclude that the outcome of low and stable inflation over the next several years is a near certainty. In fact, we believe that the risk of a significant acceleration of inflation over the medium term is the highest it has been in decades. The inflation risk emanates from three major sources: limitations of the EAPC framework of inflation dynamics, monetary policy and political risk. If it were not for these risks, then it would probably be fair to say that market expectations of a return to an inflation experience similar to that of the last two decades from the low rates being registered today are reasonable. But these risks are very real and deserve healthy consideration.

The first risk is the limitations of our understanding of inflation dynamics as explained by the EAPC framework, particularly with respect to how the business cycle affects inflation. When the unemployment rate is rising, the EAPC framework suggests that it is not a good environment for firms to pass along higher input costs to consumer prices and that therefore inflation should decelerate. Similarly when the unemployment rate is falling and the good times are roaring, typically consumer demand is strong and it is easier for firms to raise prices and thus the EAPC suggests inflation is accelerating.

The EAPC fit between the business cycle and inflation was relatively tight in the 1970s, 1980s and much of the 1990s. But beginning in the late 1990s, inflation seemed to become much less sensitive to the cyclical component of inflation. Inflation did not accelerate as much as the EAPC suggested it should in the late 1990s given how low the unemployment rate had moved, nor did inflation fall as much in the years after the 2000 recession when the unemployment rose and lingered at an uncomfortably high rate. There have been many theories about why inflation was so unresponsive to cyclical forces in the last decade, but there are no conclusive answers and it is unclear how inflation will respond going forward to cyclical forces. And herein lies the risk: if the link between the business cycle and inflation remains weak, then inflation will not slow as much as many forecasters, market participants and policy makers are anticipating.

The second major upside inflation risk is posed by monetary policy. In an attempt to offset the decline in aggregate demand, the major central banks have cut overnight interest rates to record lows<sup>2</sup>. In some cases, the central banks have conditionally committed to keep rates low for an extended period in an attempt to stimulate growth and bring unemployment rates down to more acceptable levels. With rates so low for such a long period of time, the probability of policy errors occurring increases dramatically. For example, central banks are by and large adherents of the EAPC framework and one reason that they believe they are able to keep rates so low for so long is the expectation that high rates

of unemployment will restrain inflationary pressures. If inflation fails to decelerate as the EAPC framework suggests it will, it is possible that overnight rates may already be inappropriately low. But policy errors could occur even if inflation slows, simply by central banks leaving policy too accommodative for too long.

The third and final upside inflation risk, and perhaps the most threatening risk, is political. As we discussed in our October 2008 Global Inflation Outlook<sup>3</sup>, there has been a massive deterioration in the balance sheet of many industrialised G20 nations. In fact, in many cases the deterioration is the worst since World War II and some nations will soon face debt-to-GDP ratios of over 100% for the first time since the War. The debt-to-GDP ratio is important because it represents fiscal solvency prospects. For these nations to ensure fiscal solvency, they must first stabilise debt-to-GDP ratios and later reduce them. There is a simple mathematical identity for the change in the debt-to-GDP ratio and what matters for the change are the sovereign's funding costs (or interest rates), economic growth, and the budget deficit. In other words, the path to long-term fiscal solvency for many of these nations will require very low interest rates, high rates of economic growth and/or a massive reduction in government deficits. Unfortunately for much of the Western World, the medium-term prospects for these requirements are not good.

There is another path that a sovereign can take to reduce its real liability. If the political authorities were to tolerate or encourage higher-than-anticipated rates of inflation, a sovereign's real liabilities can be reduced at the expense of its debt holders. While such an outcome sounds pernicious and unlike the experience of the past several decades, it is not at all an unusual occurrence in the history of the world. In their recent book "This Time is Different"<sup>4</sup>, Reinhart and Rogoff review nearly 800 years of financial and economic data, including episodes of high inflation. The sheer number of instances when sovereigns resorted to inflation rates of higher than 20% or 40% (including through debasement) to finance spending or pay down debt is absolutely appalling. And although such an outcome should not be remotely treated as a base scenario, in light of the high debt-to-GDP ratios that many of the industrialised G20 nations are facing and the great challenges of reducing them, the risk of higher inflation as a means of reducing liabilities should be weighted with a higher probability than before the financial crisis.

These are the uncertainties that we face in 2010. The markets are priced for low and stable inflation as far as the eye can see - a return to the inflation experience that blessed the world over the past two decades. Meanwhile, models and their forecasters believe that high rates of unemployment will be sufficient to produce such an outcome. But risks abound and we believe the markets will trade in 2010 in a way that is torn between whether the models or the risks will come out on top. That is to say that breakeven inflation will rally when sentiment shifts toward economic recovery and sell off when its attention is held by unacceptably high rates of unemployment. Nonetheless given the elevated medium-term inflation risks, we believe that 2010 is an excellent year to revisit allocations and portfolio weightings to the asset class - especially because the markets have priced surprisingly little inflation risk premium.

<sup>2</sup> As of 1 January, overnight interest rates stood at 1.0%, 0.5%, 0.1% and in a range between 0.0% and 0.25% in Europe, the United Kingdom, Japan and the United States.

<sup>3</sup> Bowman, Adam, and Weinstein, Brian. "The Price of Stability." Global Inflation Outlook, October 2009.

<sup>4</sup> Reinhart, Carmen M., and Rogoff, Kenneth S. This Time is Different: Eight Centuries of Financial Folly. Princeton: Princeton University Press, 2009.

This material is for distribution to Professional Clients and should not be relied upon by any other persons. Past performance is not a guide to future performance and should not be the sole factor of consideration when selecting a product. All financial investments involve an element of risk. Therefore, the value of your investment and the income from it will vary and your initial investment amount cannot be guaranteed.

The opinions expressed are as of [06.01.10] and may change as subsequent conditions vary. The information and opinions contained in this material are derived from proprietary and non-proprietary sources deemed by BlackRock to be reliable, are not necessarily all inclusive and are not guaranteed as to accuracy. There is no guarantee that any forecasts made will come to pass. Any investments named within this material may not necessarily be held in any accounts managed by BlackRock. Reliance upon information in this material is at the sole discretion of the reader. Inflation linked bonds are fixed interest securities where the coupon payments increase and decrease with changes in official inflation rates. Such bonds offer investors some protection against rising levels of inflation, since rising official inflation data automatically feeds through into coupon payments. However, Investors should be aware that inflation linked bonds may, under certain circumstances, offer a slightly lower coupon payment compared to other types of fixed interest securities. Also, given that these securities are not exposed to inflation rate risk, should inflation rates decrease, the value of an inflation linked bond may not increase in price as might be expected for some other sorts of bond. Issued by BlackRock Investment Management (UK) Limited (authorised and regulated by the Financial Services Authority). Registered office: 33 King William Street, London, EC4R 9AS. Registered in England No. 2020394. Tel: 020 7743 3000. For your protection, telephone calls are usually recorded. BlackRock is a trading name of BlackRock Investment Management (UK) Limited. Issued in Switzerland by the representative office, BlackRock Investment Management (UK) Limited (London), Zurich Branch, Claridenstrasse 25, Postfach 2118 CH-8022 Zürich from where the Company's Prospectus, Simplified Prospectus, Articles of Association, Annual Report and Interim Report are available free of charge. Paying Agent in Switzerland is JPMorgan Chase Bank, National Association, Columbus, Zurich Branch Switzerland, Dreikönigstrasse 21, CH-8002 Zurich. BGF has been registered on the official list of the Financial Supervision Commission (Komisja Nadzoru Finansowego) for distribution in Poland. Issued in Poland by the representative office BlackRock Investment Management (UK) Limited Oddział w Polsce, Rondo ONZ 1, 00-124 Warszawa. Paying agent in Poland is Bank Handlowy w Warszawie SA, ul. Senatorska 16, 00-950 Warsaw, Poland. Issued in Singapore by BlackRock Investment Management (Singapore) Limited. This material may only be distributed to institutional investors (as defined in section 4A of the Securities and Futures Act, Chapter 289 of Singapore (the "SFA") and accredited investors (as defined in section 4A of the SFA) and not to the retail public in Singapore. This material is for information purposes only and does not constitute an offer of shares in any of the BlackRock Global Funds. You should consider carefully whether the investment is suitable for you. Any opinions contained herein, which reflect our judgment at this date, are subject to change.

## Further Information

### Telephone

International +44 [0]20 7743 3300  
UK 08457 405 405

### Email

investor.services@blackrock.com  
broker.services@blackrock.co.uk

### Website

blackrock.com  
blackrock.co.uk

**BLACKROCK**