

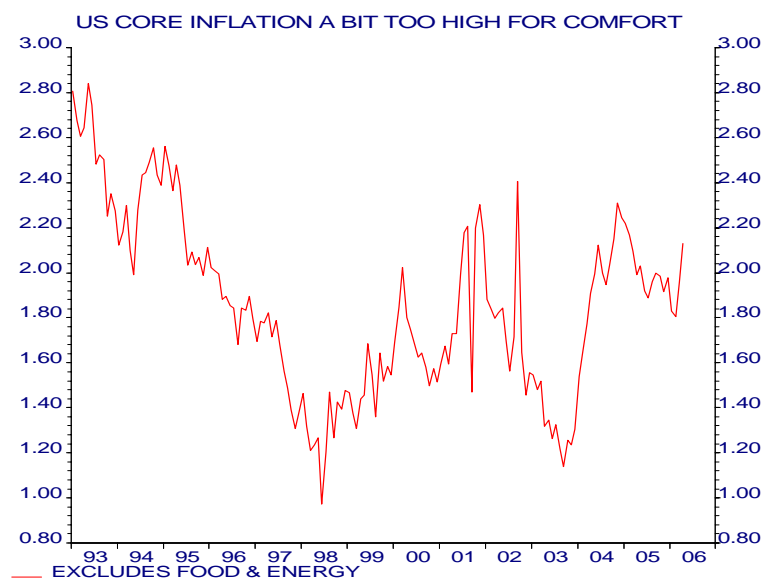
The impact of US inflation on investment markets

*By Tony Dolphin
Director of Economics and Strategy, Henderson Global Investors*

US inflation will be the key to the performance of financial markets in the rest of 2006

Financial markets have become turbulent in recent weeks, in part due to worries about US inflation, interest rates and output growth. At the root of these worries is concern that US inflation pressures have got a little out of control. If that is the case, interest rates will have to go higher to get them back under control again and this could mean weaker output and profit growth in 2007. Bond markets are weaker due to rising short-term interest rates; equity markets are weaker due to the risk to profits in 2007.

Headline inflation in the US was above 3% in 17 of the last 20 months, mainly due to higher energy prices, and in May it stood at 4.2%. This would cause grave concern to most central banks around the world. But the Federal Reserve in the US treats food and energy prices as erratic and largely out of its control, and focuses instead on measures of core inflation that exclude them. Ben Bernanke, the new Chairman of the Federal Reserve, has said that his preferred measure of inflation is one calculated using the personal consumption expenditure deflator, excluding food and energy. He has also said that his comfort zone for inflation on this measure is 1 to 2% and other Federal Reserve Governors have suggested in recent speeches that they share his view.

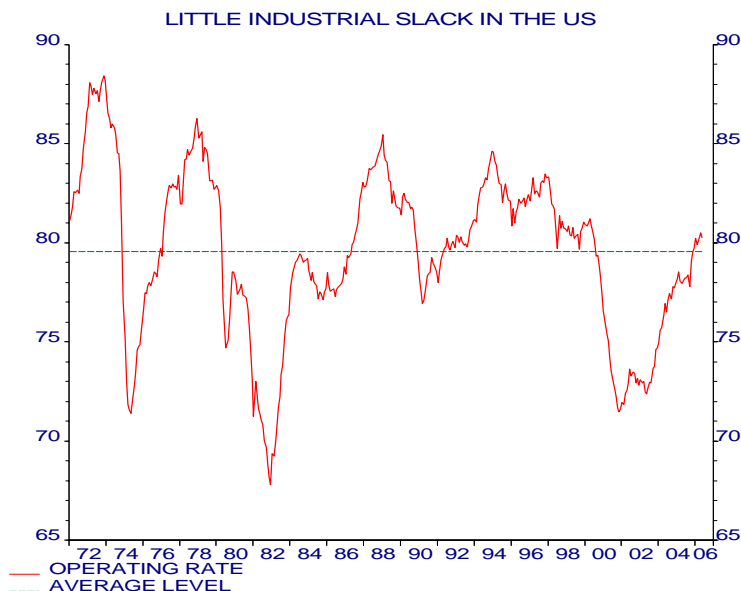


Source: DATASTREAM

This measure of inflation has averaged around 2% for most of the last year and in April it rose to 2.1%. So it is right at the top of Bernanke's comfort zone. What is more, it is likely to edge higher in the next

few months, reflecting higher costs of owning a home and the impact of sharp rises in commodity prices that occurred earlier this year. It could reach 2½% before the end of the year.

These inflation pressures will not go away soon because there is now very little slack in the US economy. Unemployment has fallen from a peak of 6.3% in 2003 to 4.6% on the latest reading and on some measures this tightening of the labour market has started to push wage inflation a bit higher. Meanwhile, the rate of capacity use in manufacturing has risen to 80.3%, a little above its long-run average of 79.6%. When spare capacity is limited, companies have more pricing power (because their competitors find it harder to increase output) and the risk now is that they will find it easier to pass on higher costs, whether they are higher labour costs or higher commodity prices, to consumers.



It is true that in the late 1990s the US maintained a higher level of capacity use and a lower level of unemployment for a number of years, without an inflation problem arising. But that was due to a unique set of circumstances. The rapid pace of technological innovation enabled companies to cut costs rather than raise prices; the strong dollar lowered import prices and – most important of all – the Asian crises of 1997/98 and the sluggish performance of the Japanese economy meant that the US could use up the spare capacity in Asia once its own economy was operating at full capacity.

Conditions are less favourable now. Technological innovation proceeds, but arguably at a less rapid pace than a decade ago. The US dollar is weak rather than strong. And output growth in Asia, including crucially China, is strong and is adding to inflation pressures by boosting oil and other commodity prices. This does not mean that the US is on the brink of a major surge in inflation, but it does mean that the Federal Reserve can take no chances. After several years of running an easy monetary policy, Bernanke and his colleagues now have to contemplate the wisdom of moving real interest rates above their average level, and keeping them there.

This is going to keep upward pressure on US bond yields, because longer term yields should reflect the future path of short-term interest rates. Higher US yields will also keep upward pressure on yields in other countries, especially as interest rates are expected to rise in Europe and Japan – and possibly in the UK – in the second half of the year.

It is also bad news for equity markets. Equities always do well in the “recovery” phase of the economic cycle, when there is plenty of spare capacity in the economy and output, and profits, can grow faster than their trend growth rate without fear of inflation. They do less well when the slack has all gone and central banks are seeking to hold growth down. This is a particular worry at present because profit margins in several countries look very stretched, making it possible that the growth in profits will weaken sharply as output growth slows.

So, unless US inflation worries evaporate suddenly and unexpectedly, the next six months look likely to be difficult ones for investors in bond and equity markets.

1st June 2006

This article first appeared in Fund Strategy