BT Investment Solutions

# The downward trend

## Could inflation keep falling?

October 2015

Inflation rates across the developed world have consistently been weaker than expected since the global financial crisis. This has compelled banks into ultra-easy monetary policy including quantitative easing. As long as inflation stays low, this policy environment will likely continue, and will be a support for asset markets.

In this paper, Tim Rocks argues that there are a number of structural issues that indicate that the trend for low inflation will continue. These include:

+ A decade of overbuilding and business investment
+ The rise of China
+ Technological innovation

### 1. A decade of overbuilding and business investment

The 2000s saw one of the most aggressive periods of business investment in history. Even the downturn during the financial crisis was shallow and short-lived due to substantial stimulus measures introduced in China. The result is substantial industrial overcapacity globally. The high proportion of fixed investment for businesses is shown in Chart 1. Firms have no pricing power and are now cutting prices to maintain sales and cover the heavy fixed costs that come with a large capital base.

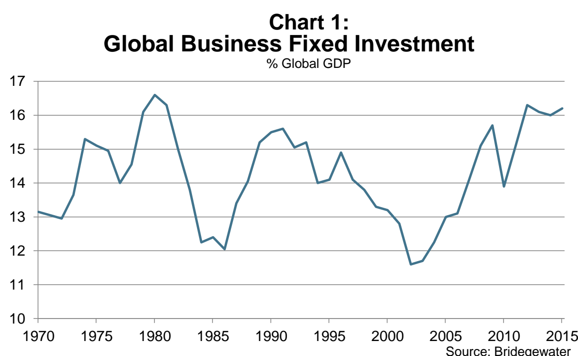



**Chart 1: Global Business Fixed Investment**

### 2. The rise of China

China led the surge in investment with a rapid development program. China's growth has also driven a growing gap between investment in advanced and emerging economies (as shown in Chart 2). The speed of China's transformation created an imbalance in commodity markets that lifted prices and incentivised capital spending by commodity producers that then further extended the investment boom. This created a virtuous circle of rising investment creating even more investment.

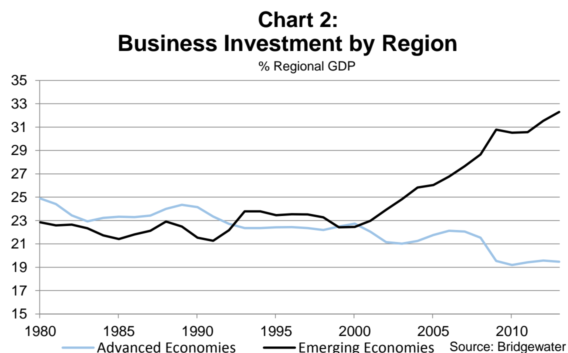


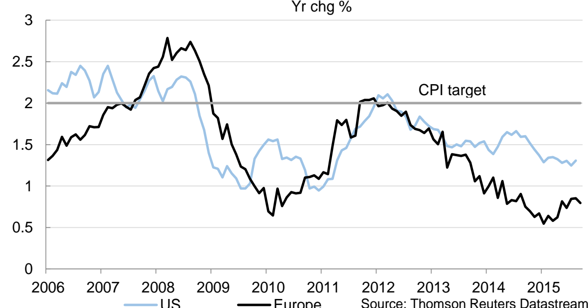

**Chart 2: Business Investment by Region**

However overcapacity from business investment and from China's growth is not the only deflationary force.

## 3. Technological innovation

The latest wave of technology innovation is also forcing prices lower. Examples include peer-to-peer websites like Uber and AirBnB that offer lower prices than their old economy counterparts, online sales, 3D printing, greater mobile connectivity and advances in energy storage. There has also been an acceleration in structural reform in parts of Europe in the aftermath of the financial crisis that will lead to lower wages growth.

**Chart 3:**
**US and European Core CPI**

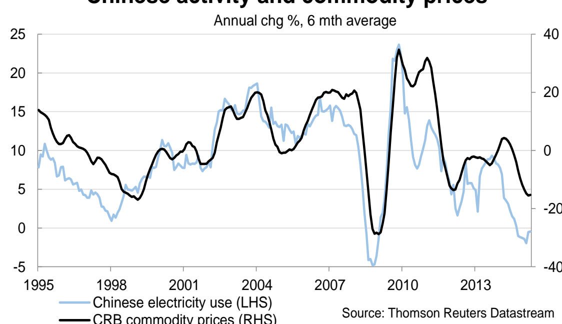



As a consequence, inflation rates across the developed world have been consistently below target since 2012 (as shown in Chart 3 for Europe and US). These structural forces have dominated potential inflationary pressure from tightening labour markets, particularly in the US.

## Ongoing challenges for inflation

The important point of these structural issues is that deflationary pressures are likely to persist. The overhang from business investment could take some years to work through and the Chinese economic transition has only just commenced. Chinese growth has a particularly significant impact on commodity prices which is one of the main channels through which a Chinese slowdown affects global inflation as shown in Chart 4.

**Chart 4:**
**Chinese activity and commodity prices**




## Central banks will do more not less

These deflationary forces also have important implications for central banks. They will be under pressure to introduce more and different types of stimulus to try and lift inflation rates back towards their targets.

Over the past couple of years, investors have debated the timing and extent of policy tightening and the negative impact this might have on asset markets, particularly equities. Our analysis suggests that this is the wrong debate. Instead investors should be considering what central banks will do in their next round of attack against these deflationary forces. As long as deflation remains a larger risk than inflation, monetary settings will likely remain easy and a support for most asset classes. Property investment, for example, may benefit from the low official cash rates that are typically one of the tools used by central banks while other types of businesses also benefit from lower interest repayments on existing capital investments. Fixed interest markets can also be buffered by these settings.

**For more information about how inflation impacts your investments, please contact BT Investment Solutions.**

This document has been created by BT Financial Group Limited (ABN 63 002 916 458). It provides an overview or summary only and it should not be considered a comprehensive statement on any matter or relied upon as such. This information has been prepared without taking account of your objectives, financial situation or needs. Because of this, you should, before acting on this information, consider its appropriateness, having regard to your objectives, financial situation and needs. Projections given above are predicative in character. Whilst every effort has been taken to ensure that the assumptions on which the projections are based are reasonable, the projections may be based on incorrect assumptions or may not take into account known or unknown risks and uncertainties. The results ultimately achieved may differ materially from these projections.

Information current as at 29 October 2015. ©BT Financial Group 2015.