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Morgan Stanley Australia Limited+
Gerard Minack
Gerard.Minack@morganstanley.com
+61 2 9770 1529

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Downunder Daily

Stagflation Consternation

The immediate response to the Fed's rate cut – rising bond yields, rising gold prices, a weaker US$ – hinted at rising inflation concerns. Inflation concerns and growth worries: Is there really a risk of stagflation – if not now, then at some stage in this cycle?

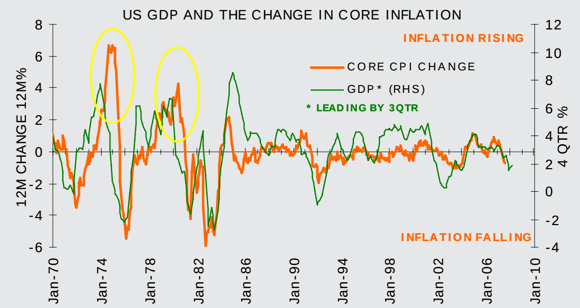
Our US team thinks this is very unlikely, and I agree. As Dick Berner has already noted (*Reflation, Inflation, or Dollar Flight*, 21 September), the Fed's cut is best seen as insurance policy against economic weakness, one that doesn't add significantly to inflation risks. The market reaction since – equities sharply higher and bond yields now 20 basis points off their post-FOMC highs – suggests an ideal mix for investors of solid growth and low inflation.

Time will tell whether the Fed has (or will) take out enough growth insurance. But if growth does weaken, inflation pressures are likely to moderate. Stagflation seems a very, very low risk in anything but extreme circumstances.

To see why, note that inflation almost always falls when US growth slows to below trend. Exhibit 1 shows the change in core inflation (that is, whether inflation is running above or below year-earlier levels) and GDP growth. Inflation is now easing, in line with that relationship. Even in the 1970s, the era that coined stagflation, this held true. What was unusual about the 1970s is that inflation initially rose higher than expected when growth was strong, and then fell less than expected when growth was weak.

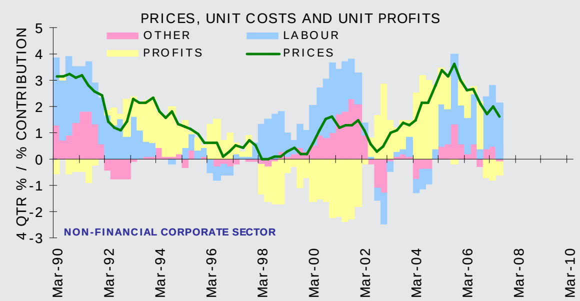
An important reason why inflation falls when growth weakens is that corporate profit margins get squeezed. This is partly due to the corporate sector's operational leverage (Exhibit 2). This, to state the obvious, is why equities do poorly in recession – even though the Fed is easing policy.

Exhibit 1
Lower Growth Lowers Inflation



Source: BLS, BEA; Morgan Stanley Research

Exhibit 2
Margins Bear the Brunt of Slower Growth

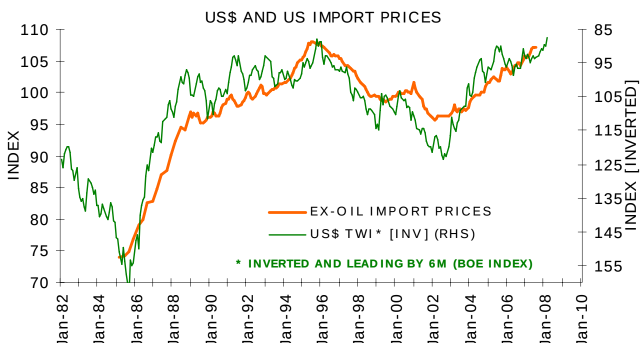


Source: BEA; Morgan Stanley Research

The principal reason why the weaker growth did less than usual to dampen inflation in the 1970s was that structural factors blocked the usual adjustment in prices (in labour as well as product markets) to a fall in demand. Not only was the labour market far less flexible than it is today, but there were more regulated prices (in fact, for a period, broad-based price caps under the Nixon Administration).

Clearly, these structural problems don't exist today. Instead, however, there may be a risk that a falling dollar could lift inflation, even as growth weakens.

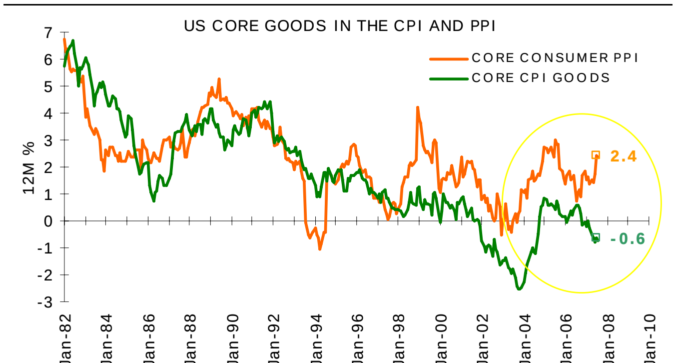
Exhibit 3
Dollar Weakness Adds Some Pressure



Source: BLS, Bank of England; Morgan Stanley Research

Barring a full-blown dollar crisis, that also seems unlikely. As Exhibit 3 shows, there is a close relationship between import prices and the dollar (which is inverted in the chart, so the line goes up when the dollar goes down). That relationship seems to have been fairly consistent over time.

Exhibit 4
Inflation Not Reaching the Consumer

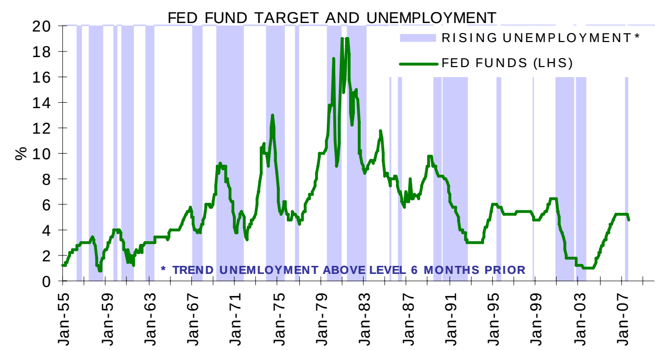


Source: BLS; Morgan Stanley Research

What has changed, however, is the flow-through from import prices to consumer-level prices. Exhibit 4 shows the price of consumer goods at the retail level and as import prices. The link between the two has become more muted over the past half-decade. In other words, a softer dollar seems less inflationary today than it has been in the past (despite the growing share of traded goods in the total sales mix).

While it is right to assume that the dollar could fall fast enough to generate some inflation flow-through, if growth were weak, there would likely be a more-than-offsetting fall in domestically sourced inflation.

Exhibit 5
Fed Always Cuts When Growth Is Weak



Source: BLS, Federal Reserve; Morgan Stanley

In a practical sense, if growth indicators do continue to deteriorate, then the Fed will further ease policy, regardless of what the inflation data may be showing at the time. This would be consistent with history: Exhibit 5 shows that the Fed almost always eases policy – and keeps easing – whenever unemployment is trending higher. It seems very unlikely that the Bernanke Fed would break this pattern.

My only concession to stagflation concerns reflects what may happen in extreme circumstances. If the US did fall into recession, if the Fed's conventional response didn't appear effective, and if Dr Bernanke did start helicopter drops, then stagflation might be a risk. But there are a lot of 'ifs' there, far too many to base an investment decision on now. In any case, the likely trigger for such an extreme policy response would presumably be a major deflationary scare.

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The Americas
1585 Broadway
New York, NY 10036-8293
United States
Tel: +1 (1) 212 761 4000

Europe
25 Cabot Square, Canary Wharf
London E14 4QA
United Kingdom
Tel: +44 (0) 20 7 425 8000

Japan
4-20-3 Ebisu, Shibuya-ku
Tokyo 150-6008
Japan
Tel: +81 (0) 3 5424 5000

Asia/Pacific
Three Exchange Square
Central
Hong Kong
Tel: +852 2848 5200