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MORGAN STANLEY RESEARCH
ASIA/PACIFIC

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Downunder Daily

Inflation: Not Now, Later

I'm not worried about inflation, at least not this year. I'm not worried about inflation because I'm worried about growth. A material slowdown in developed economies should ease global inflation pressures even if emerging markets keep growing.

Part of the story is the surprisingly low inflation seen in this cycle. If I had known in 2003 that the globe was about to average four years of 4½-5% real growth, and that commodities prices would rise by several hundred percent – including oil going from US$20 to $100 per barrel – then I would have expected hair-raising inflation rates by now. Instead, the expansion has simply brought to an end the disinflation that started with the Asia crisis a decade ago (Exhibit 1).

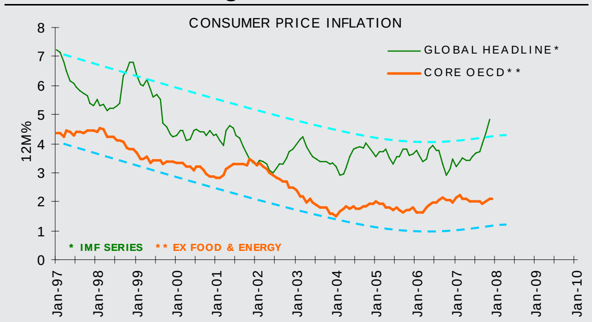
The slowdown likely this year should ease capacity constraints, although not to the same extent as the Asia crisis (or the TMT bust) did. Excess capacity points to lower inflation (Exhibit 2). As an aside, this is one reason why emerging market earnings growth may be less resilient to developed economy weakness than GDP growth: Supply-boosting growth, such as spending on infrastructure, will continue, but the resultant increase in capacity may pressure profit margins.

Global deceleration may also see commodity prices soften. In fact, as inflation is all about the rate of change, commodities' contribution to consumer-level inflation would moderate if prices flat-lined (Exhibit 3).

Having said all that, it does seem likely that the next cycle upswing will trigger inflation concerns earlier than the expansion phase we are now finishing. This is partly because if the recession is not global, there will be less excess capacity at the cycle low than has been the case in the prior two cycles.

Exhibit 1

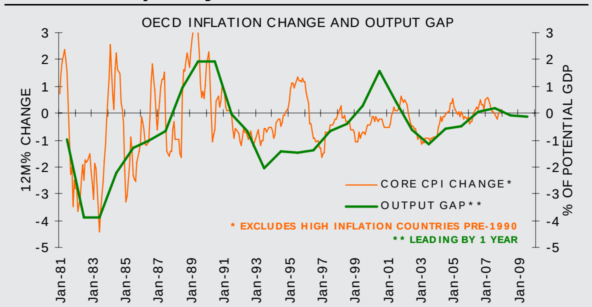
Not Bad, All Things Considered



Source: OECD, IMF; Morgan Stanley Research

Exhibit 2

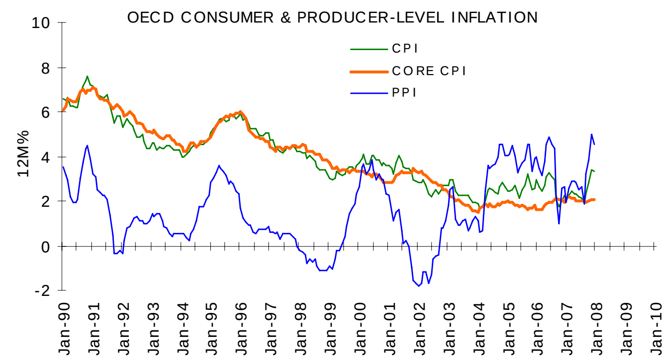
Excess Capacity Should Moderate Inflation



Source: OECD; Morgan Stanley Research

Even in the developed economies – which are likely to bear the brunt of the slowdown – the downturn may lead to less excess capacity because business investment has been unusually weak through the expansion. Exhibit 4 shows that the usual link between corporate returns and investment spending in the developed economies broke down in this cycle: Investment has decelerated even as returns improved. Presumably, this is a reaction to the excesses of the last cycle. It also suggests that the downturn will leave a smaller-than-usual legacy of excess capacity. (This may also explain why, for example, French corporates recently upgraded their spending plans: See Eric Chaney, *Insee Investment Survey: Capex Plans Upgraded*, 13 February.)

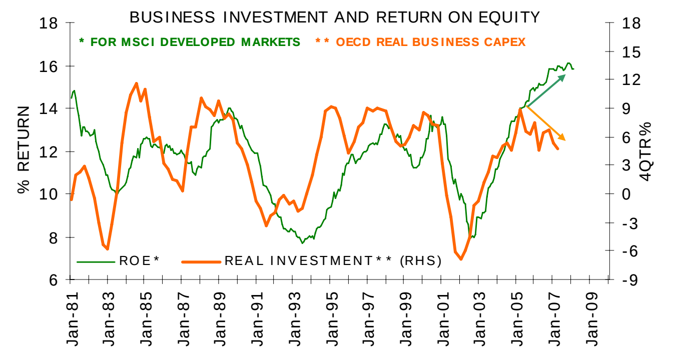
Exhibit 3
Material Prices Matter Less Than You Think



Source: OECD; Morgan Stanley

Arguably, inflation pressures may also come sooner in the US in the next cycle upswing because of the likely resumption of dollar weakness. Dollar strength enhanced imported deflation through the late 1990s, but has now reversed (Exhibit 5). Our FX team, however, expects a counter-trend rally in the US$ this year as risk appetites diminish. But the dollar's decline will likely resume as global growth re-accelerates.

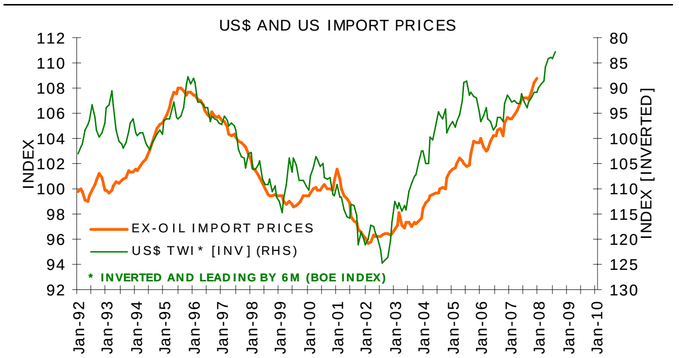
Exhibit 4
Next Cycle Upswing May See Problems



Source: OECD, MSCI; Morgan Stanley Research

In fact, the most bearish inflation scenario I can come up with for the US is if there were a 'hard' decoupling this year, that is, if the US slipped into recession and the rest of the world kept growing strongly. (This is not what we expect: See Richard Berner, *The Year of Recoupling*, 11 February.) In that scenario, commodity prices would likely remain high, and there could be an accelerating dollar decline: The vendor financing arrangement of the past decade – foreigners (Asia) buying US debt and the US buying their exports – would break down as US recession capped imports. As a result, there would be little or no incentive for foreigners to buy US paper. This would be very US$ bearish. In other words, if you're looking for a decoupled world to cushion the US recession, it's a case of "Be careful what you wish for…" But there may be a milder dose of the same shift next year.

Exhibit 5
And the US May Face Particular Problems



Source: BLS, BOE; Morgan Stanley Research

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