Business Standard

Issues to ponder over in 2018

Global investors should watch out for inflation and withdrawal of liquidity

Akash Prakash January 08, 2018 Last Updated at 22:43 IST

The past year was a great one for financial assets, with most asset classes giving strong positive returns. Equities globally were up almost 25 per cent, led by emerging market stocks which rose 38 per cent in dollars, and even bonds and treasuries delivered positive real returns. All commodities except agricultural delivered strong returns as well, led by the industrial metals which were up by 29 per cent.

We are currently in a sweet spot for financial assets, with global growth strong and synchronous and monetary conditions remaining benign. Both corporate and consumer confidence are surging and most leading indicators of economic activity show continued strength. Most economic forecasters expect growth to accelerate further in 2018. Given how strongly markets have started 2018, what — if anything — should investors worry about?

The number one issue that comes to mind is the threat of inflation. Undoubtedly most structural trends, be it digitalisation, the onset of artificial intelligence and robotics, and demographics, all point towards continued deflationary tendencies across the globe. When combined with the supply shock coming out of China over the past 15 years, deflation has clearly won the battle of fire versus ice (inflation versus deflation), so much so that there are very few believers in inflation today. In almost any investment shop, there is very little talk of inflation or even a game plan to counter its re-emergence and create a hedge in the portfolio. Believers in inflation coming back have either been fired or forced to keep quiet. Even central banks seem to focus almost entirely on preventing deflation, very little on inflation. The belief in deflation is so pervasive that it has almost certainly been priced into financial assets. Despite the initial signs of prices starting to move up, there seems to be no concern on the part of investors. Calling for a rise in inflation is almost akin to crying wolf; investors have been consistently burned, waiting for it to re-emerge. It has been a failed trade for the past so many years.

The reality is that the unemployment rate in the US is now at 4.1 per cent, if not at full employment, we must be very close. It is highly unlikely that the Nairu (non-accelerating inflation rate of unemployment) can be lower than 4 per cent. At this juncture, with a tight labour market, you have the US passing a large fiscal stimulus, through the tax cuts, and possibly following it up with a large infrastructure spending legislation. If either of these measures stimulates consumption or investment spending in the US, it will lead to inflationary pressures building up. It is true that commentators have been worried about the low unemployment rate and the potential for higher inflation in the US for some time now, but the Trump tax cuts may be the last straw.

Illustration by Binay Sinha

We also have oil prices surging, nearing $70 on Brent, combined with copper and other metals also rising by 20-25 per cent. There has also been a general lack of investment across the globe for the past few years, which is now showing up in utilisation rates.

On a more fundamental level, the deflationary pressures coming out of China have dissipated. Over the past 15 years, China has added manufacturing capacity on an unprecedented scale, combined with millions of workers moving from the countryside into manufacturing. Both of these trends are now reversing; China has imposed strict supply side cuts — be it in coal mining, steel capacity etc. Capacity has genuinely been taken out of the system, with limited new investment in manufacturing capacity. The migration into manufacturing jobs in the cities has also reduced as over 60 per cent of Chinese workers now reside in cities already. The average age of the workers still in the villages is also rising, reducing their mobility. The days of tens of millions of new workers migrating every year are over. Already we can see Chinese prices rising. Both producer prices and prices of goods exported from China are climbing. This is at a time when prices have already started inflecting across many developed economies. Needless to say markets currently are not priced for any resurgence in inflationary pressures. Rising inflation will obviously lead to a spike in bond yields, cause a tightening in monetary policy conditions and invariably impact price earnings multiples and valuations more broadly. It will also cause a rotation from growth stocks back to value. Whenever rates rise long duration assets suffer the most.

The second issue to keep an eye on is oil prices. They have consistently kept moving up over the past quarter, with Brent now almost $70 per barrel. The rise is due to coordination between Saudi, Russia and Iran, combined with strong demand linked to the recovery in global growth. The reduced investment over the past few years may also be taking a toll, as shale oil/gas has far sharper depletion rates and thus greater capital intensity. A rise in oil prices also sucks out liquidity from markets. The world consumes about a 100 million barrels of oil per day. Assuming 100 days of inventory in the system, a $20 rise in price needs $200 billion of additional working capital. Some of this liquidity will get diverted from financial markets. Rising oil prices combined with a tightening Fed is not normally good for financial assets. Both suck liquidity out of financial assets.

As for India, we need to worry about corporate earnings. This is the year when earnings need to deliver. Multiples have no room to expand further. Interest rates have bottomed, the macro on the margin is deteriorating. It is earnings which matter now. The delivery of earnings or lack of by corporate entities will determine what markets do in 2018.

The writer is with Amansa Capital. Views are his own