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All Roads Lead Through China

By: Allan Seychuk

We live in a world awash in money. Liquidity is at the heart of today's persistently low long-term bond yields, extremely tight credit spreads, and abnormally low volatility. By looking at the ease of buying and selling financial assets, the Bank of England recently calculated that markets are more liquid today than they were at the height of the dotcom bubble in the late 1990s.

Liquidity has also facilitated a tremendous increase in asset prices since the early part of this decade. However, one of the most striking aspects of today's economy is the fact that all this money sloshing about has not led to much of an increase in core inflation – that is, inflation outside of food and energy prices. How can this be? And, will it last? Although we don't pretend to have the definitive answer, the search for one suggests that all roads lead through China.

Curiously, while no consensus has emerged on how to define liquidity, there's no debating that there's lots of it (See Chart 1). Moreover, there can be no mistaking the impact that liquidity has had on global financial markets. The month of May 2007 brought new record highs for the S&P/TSX, the Dow, and the S&P 500. These gains pale in comparison to the MSCI Emerging Markets Index which has nearly tripled from its 2002 low, powered by staggering gains in Brazil's Bovespa (475 per cent), Russia's RTS (535 per cent), India's Sensex (390 per cent), and China's Shanghai Composite (150 per cent), among others.

Last, but not least, we are in the midst of the most pronounced house price boom in history. According to the S&P/ Case-Shiller Home Price Index of the 10 largest U.S. cities, prices are up 182 per cent in the last decade. In Canada, we've seen gains over the same period ranging from 80 per cent in Toronto to 100 per cent in Vancouver and nearly 200 per cent in Calgary and Edmonton.

Traditionally, excess money relative to economic activity leads to both asset price inflation and consumer price inflation. In fact, asset price inflation itself tends to cause consumer price inflation because rising demand for assets causes people to try to create more of those assets (and get paid for doing so) and because of the wealth effect where people spend part of their financial profits on more goods and services. However, today's strong liquidity growth and exceptional asset price inflation have not had much of an impact on consumer price inflation at all, outside of energy prices (See Chart 2). With very few exceptions, core CPI in Canada and the U.S. has remained within a one per cent to three per cent band since1994 (See Chart 3). Even overall inflation, while much more volatile, has generally remained within a one per cent to four per cent band over this period.

Why So Little Inflation?

We're left with a unique phenomenon of non-inflationary liquidity. Booming asset prices have been accompanied by goods inflation that's been downright boring so far.

There are a couple of potential explanations for this.

One is that the liquidity that's being created in financial markets is not being spent on consumer goods to the same extent as in the market booms of the late 1980s and '90s. Asset price inflation that takes place in corporate bonds, financial derivatives, infrastructure, commercial real estate, commodities, emerging market debt, and equities doesn't tend to find its way into the bank accounts of average investors to be available for spending. Institutional investors dominate these markets and the gains from asset price inflation end up expanding the assets of pension plans and life insurance companies, instead of being spent on goods and services. Other players – hedge funds, private equity funds, and other specialty vehicles – are usually narrowly controlled and often work on behalf of other institutional investors.

The second reason for low inflation relates to the nature of the spending that is taking place. The housing boom has certainly led to much higher consumer spending on goods and services. Even so, core CPI inflation has been mild even in countries that have had a stronger house price boom than the U.S. A housing boom leads to increased spending on furniture, household goods, and other home-related products. Chinese producers increasingly dominate these markets. Even for products not typically produced in China, such as automobiles and their parts, the threat of moving production to China (or other low-cost countries) has created a dampening force on wage demands, allowing producers to keep price inflation low. As a result, we're seeing supportive conditions for both equities (high liquidity) and longterm bonds (mild inflation).

How Long Will This Last?

Liquidity is notoriously fickle and can dry up suddenly on a change in market sentiment. An increase in investors' risk aversion would cause credit spreads to widen, making debt more expensive and less attractive for leveraged buyouts and private equity deals (See Chart 4). It is impossible to know what type of event would cause credit spreads to widen by enough to put an end to the current flurry of activity. All we can say is that markets have proved to be resilient so far.

Having said that, there are still more than 200 basis points separating 10-year U.S. Treasury yields and the S&P 500 earnings yield and this sustains the incentive to borrow in bond markets and invest in riskier equities. Capital continues to accumulate in the hands of private equity, putting once-untouchable companies within reach of leveraged buy-out activity. The same incentives are behind a sharp increase in corporate leverage.

There are also structural elements to today's liquidity deluge that seem likely to persist for some time. Special factors such as the yen carry trade and the demand for long-dated assets by pension plans have inflated asset prices and pushed down borrowing costs. With prices in Japan falling once again, the Bank of Japan is unlikely to quash the yen carry trade anytime soon. At some point, the duration of pension plan assets will become aligned with liabilities and this source of demand for long-dated product will subside – but we are not there yet.

The China Factor

We said at the outset that all roads seem to lead in some way through China. The accumulation of $1.2 trillion in foreign exchange reserves by China may have become more important than central bank policy interest rates when it comes to setting global liquidity conditions. The shift in trade patterns between China and the United States is structural, driven as much by the supply chain patterns of large U.S. firms as by Chinese exporters. With enough political pressure, further yuan appreciation, and a weakening U.S. dollar, the China-U.S. trade imbalance may begin to turn around, but the process will be long and arduous.

Meanwhile, the Chinese economy is still firing on all cylinders and authorities are struggling to find ways to cool it. As the nation's trade surplus sets new records, domestic money supply growth accelerates. To restrain money growth, China has raised interest rates, but this, along with the expected currency appreciation, has attracted more hot money, exacerbating capital inflows and further swelling central bank coffers. In finding a home for this foreign currency, China continues to fuel asset prices.

In terms of the outlook for inflation, we are starting to see core prices creep up in many countries. It's still unclear if this is the end of the benign inflation environment. Over the shorter term, slower growth might reduce inflation a bit as capacity pressures are alleviated and weaker housing markets will reduce the upward influence from house prices. If we get an ugly shock that causes a spike in risk aversion, we may also see inflation come back down fairly quickly.

From Soup To Nuts

The medium term is more interesting as there is, on the one hand, interplay between higher food prices and looming labour shortages and, on the other, globalization, deregulation, and falling technology prices. Lately, news has been dominated by the upward drift in core CPI coming from food prices. The use of corn in the production of fuel ethanol has caused U.S. corn prices to rise 50 per cent from their 20-year average, impacting the price of everything from tortillas to beef. Central banks are trying hard to ensure higher food prices don't get baked into inflation expectations.

China also has a key role to play in medium-term inflation patterns. Inside China, higher food prices are causing inflation to pick up. This is great for the majority of citizens still dependent on agriculture, but more income means more domestic demand for consumer products – and, potentially, even more inflation.

Even more importantly, recent reports suggest that China's tremendous wage advantage has begun to narrow. Anecdotal evidence points to skilled labour shortages in key manufacturing regions. Wages are climbing as a result, albeit from a very low base. While there are still tens of millions of unemployed in China and a huge surplus labour force, there is a growing mismatch between available jobs and the types of workers to fill them.

China's miracle is based on its seemingly inexhaustible supply of labour. In assessing China's demographic trends, we believe that China should continue to be a force for goods price deflation for the balance of this decade. But if current growth rates persist, China will face growing labour shortages and will likely cease to be a downward force on consumer goods prices sooner than many expect.

There is a growing feeling that capital markets are running on borrowed time, based on an unusually low price of risk. We don't disagree. Inflation is drifting up, while liquidity is vulnerable to sudden changes in sentiment.

However, we acknowledge that we're in uncharted territory. In their efforts to shape today's liquidity conditions, central banks have been less successful than in the past. Higher short-term interest rates have not led to higher long-term rates or less borrowing. Ironically, while central banks may have lost some control over the long end of the yield curve, they probably exert more control over infl ation expectations today than they ever have. In addition, there are still some powerful structural forces for lower inflation at work, though these will have to compete with aging populations, water shortages, and rising incomes and food consumption in developing countries.

For now, we have a situation in which liquidity and strong demand can push asset prices higher while core inflation and longer-term inflation expectations remain subdued. Looking out longer-term, rising food prices and increased protectionism could threaten today's benign inflation environment. If, and when, liquidity dries up, asset prices will cool off just as consumer price inflation is picking up. Make hay while the sun shines. ■

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