THE AUSTRALIAN

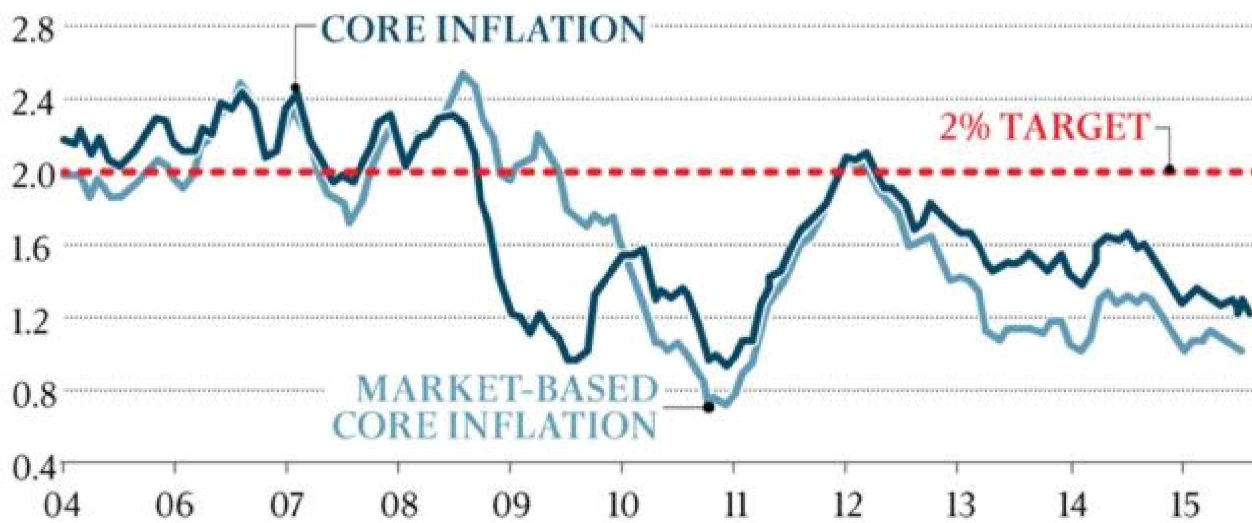
STOCK QUOTES Enter company code

MARKET CBA -1.18% 73.39 | IAG -1.22% 4.85 | AMP -1.24% 5.59 | CSL -1.56% 88.54 | WBC

S&P/ASX 200 -1.18% 5052.0000
AUD/USD +0.25% $0.71
TOP GAINER LNG +5.22% $1.41
TOP LOSER CSR -5.78% $2.77

It's time for a fresh rethink of 'balancing act'

STIRLING LARKIN THE AUSTRALIAN OCTOBER 03, 2015 12:00AM



US inflation is well below the Federal Reserve's 2% target, and falling. Source: TheAustralian

Within a financial world awash with noise and misinterpretations, there fortunately remain several clever and rational voices reminding us how best to approach global investing in this new era of "unknown unknowns" and conflicting indicators.

Many in particular remain baffled as to why US official inflation continues to flatline despite the US Federal Reserve injecting $US4.5 trillion ($6.41 trillion) into the US monetary supply during the past seven years.

This central question matters most to the global investor for no other reason than that decent levels of inflation in the world's leading economic powerhouse traditionally correspond to global economic growth — which, at the end of the day, is all that any of us desire.

One of these voices, Ray Dalio, founder of the world's largest investment management firm, recently passed a small but significant comment that so many others, until now, have completely missed.

He reminded us that the primary amplifier of inflation is spending and it can come in either of two forms: money or credit.

Although US quantitative easing injected $US4.5 trillion into the US monetary supply, US QE also, at the exact same time, deleveraged and therefore deflated the quantity of credit spread throughout the US economy.

Dalio was simply reminding us why monetary and credit spending have netted themselves out which means total spending remains relatively flat, resulting in only small amounts of measurable official inflation.

So simple, blatantly obvious and yet still widely misunderstood by the learned and layman alike.

Framed within this light, it becomes extraordinarily clearer why the global investor has seen US asset inflation — represented in highly priced equities seen on the S&P 500, in debt via US 10-year Treasury yields and currency via a robust US dollar — rally but official inflation metrics underrun desired and expected targets, as seen in the graph.

What this reminder also reiterates to the global investor and especially the ultra high-net-worth investor in particular — who has to decide their desired split between equities, fixed income, alternatives and/or cash — is that these dual sets of parallel inflation realities are mutually exclusive and also equally foretelling.

What also puzzled many professional economists and analysts in September was not that Federal Reserve chairwoman Janet Yellen and the Federal Open Market Committee chose to keep interest rates unchanged but rather that they decided to lower their non-accelerating inflation rate of unemployment level below the sacred 5 per cent level, in a dedicated effort to stoke further employment throughout the US economy.

To understand why this recently shocked many and was taken as economic blasphemy, it is important for the global investor to actually appreciate what NAIRU represents and why 5 per cent apparently typifies the natural level of desired long-term employment within any economy.

The concept of NAIRU was born out of the central thesis within what's referred to as the monetarists school of economics, which rose to popularity during the late 1960s.

Monetarists such as Milton Friedman believed that an economy's performance was determined almost entirely by changes in the monetary supply and that there did exist a maximised level of employment at which inflation would not be unduly stimulated and that price stability could be maintained.

What price stability meant, in practice, was that healthy levels of spending continued via whatever form it came.

The constitution of this form — whether it was derived from money or credit — did not really matter up and until the great recession; all that mattered until then was that the money supply and spending mechanism worked, and worked well.

This NAIRU level had to mean something because it was thought anything past this threshold would then inflate industrial and consumer prices, which inevitably would lead to redundancies and higher unemployment.

The decision by Yellen, who professes to be data-driven, to leave interest rates unchanged at zero and at the same time lower NAIRU below the 5 per cent threshold understandably confused markets and global investors alike.

However, circling back to Dalio's simple yet profound reminder, spending can come in two forms.

And respecting that the post-QE US economy is flush with more actual money but still midway

through a historical deleveraging of its longer-term debt and credit cache, what Yellen and the Federal Open Market Committee have signalled to the global investment community is that there needs to be a fresh rethink about this balancing act. This rethink regarding the inflation vis-a-vis unemployment relation going forward may include three, not two components: first, official headline unemployment; second, core inflation; and, third, asset inflation.

Revising official US inflation measures is nothing new. After all, the US Bureau of Labour Statistics first set out to devise a measure of prices in 1917 to learn what it cost an American family to meet its basic needs and have been revising these assessments ever since.

Before our present-day consumer price index measurement became standard in the US in 1977, portions of asset inflation, especially the price of retail petrol, which today is considered a commodities asset class, were included in core inflation readings.

Accepting Dalio's wisdom, and remembering that changing financial conditions can often call for fresh interpretations, places the global investor at the same table as Yellen and her committee.

Even though joining this table does not afford any of us additional insight into what may happen in the future it does allow us to position preferences across the asset allocation "decision-tree" ahead of whatever may happen to US interest rates: whether they rise, fall (to subzero negative rates) or even if the absurd notion of QE4 becomes a reality.

Wisdom is indelibly linked to experience and experience teaches us that when the world needs to change, so do we.

Larkin Group is a wholesale wealth adviser focusing on high-yielding global investments.

www.larkingroup.com.au *(http://www.larkingroup.com.au)*