RICHES FLORES RESEARCH

GLOBAL MACRO & THEMATIC INDEPENDENT RESEARCH

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GLOBAL MACRO

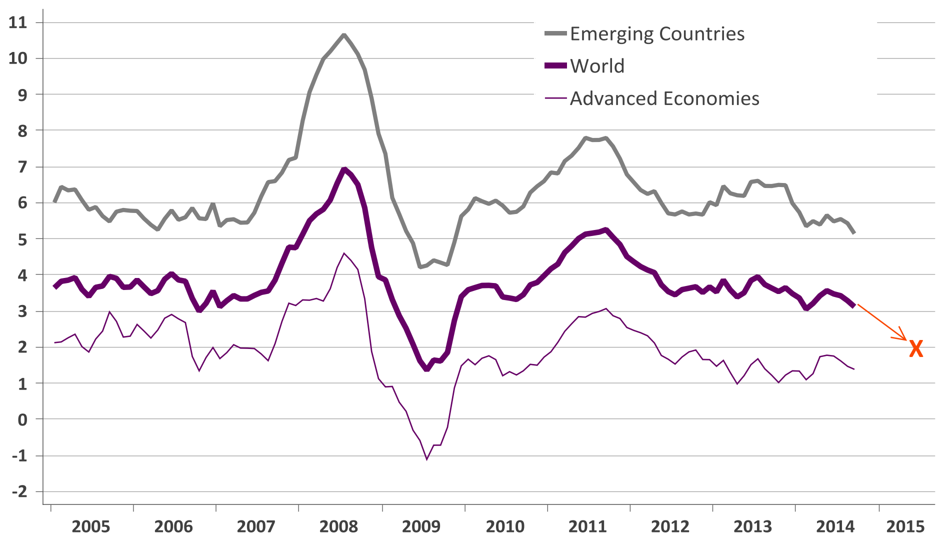
Price of oil, global inflation and T-Bonds

Disinflation continues to gain ground around the planet and things don't seem poised to improve anytime soon. The effects of the drop in global oil and agricultural commodities in the coming months will compound the consequences of sluggish growth amid persistent competitive tension. Global inflation could fall to around 2.5 % to Q1 2015 while a growing number of economies slip into negative inflation territory. Such an environment could very well lead to a new slump in global interest rates…

Global inflation dipping to 2.5% before spring 2015?

After a period of stabilization in recent quarters, global inflation seems to be headed for a marked downturn in the coming months given trends on the oil front. Thus, supposing global oil prices settle at around $80/barrel to early 2015, the global rate of inflation could fall from 3.3% in August 2014 to 2.5 % in March 2015. The end of the tax effect in Japan could even drop this rate under the 2.5% mark, which would be on par with 2009 lows.

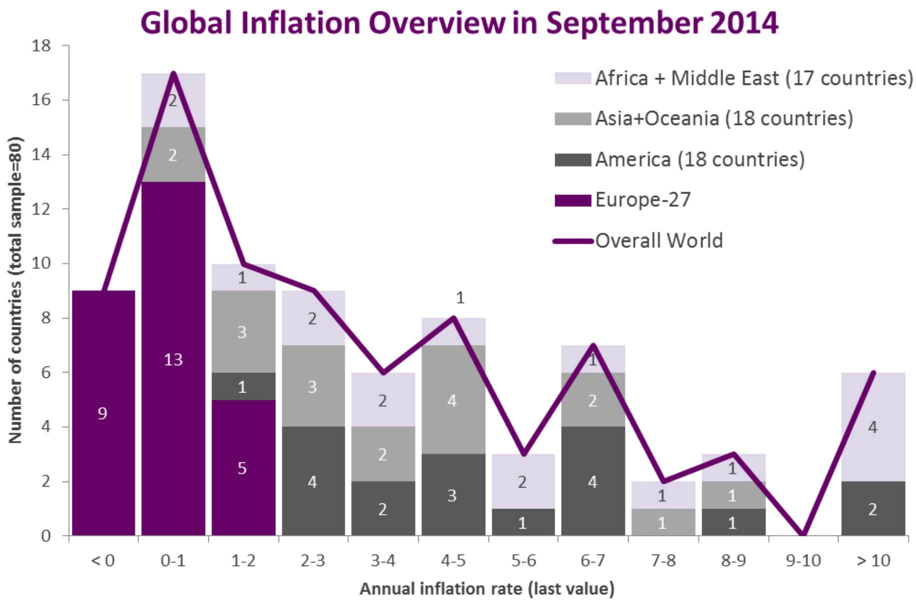
World Inflation, %



Sources: RichesFlores Research, Macrobond

Negative inflation in a growing number of economies around the world

Already less than or equal to 1% in one-third of the 80 countries in our sample, inflation could fall into negative territory in a growing number of developed and emerging economies. First and foremost, Europe, obviously, where inflation in the vast majority of countries will break the zero barrier in the coming months. But the bad news doesn't stop there. Many Southeast Asian countries, where inflation has fallen considerably as of late, could see their inflation rate soon fall below zero. Other countries in North Africa, Latin America could also follow in their wake.



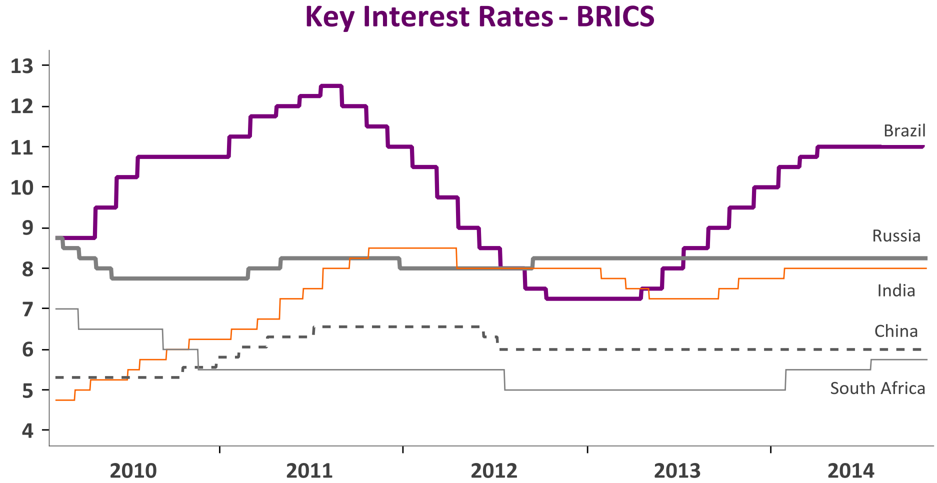
Sources: RichesFlores Research, FMI, Macrobond

Such a development in global inflation does not bode well… Inflation that is too low - or even negative - is hardly propitious to the investment growth needed if developed countries or emerging markets are to improve their economic outlooks. Many heavily-indebted countries could suffer from debt ratios that would automatically rocket due to low or negative inflation. International financial risk increases when too low inflation hurts profitability.

An environment favoring lower interest rates

This outlook, despite rising financial risk, could spark additional falls in interest rates around the world.

Many emerging markets should, in fact, be able to proceed with downwards adjustments to their key rates. This is notably the case for the BRICS – except Russia which is in the grips of a sharp rise in inflation and a drop in the ruble – as well as many other EMs where current disinflation will enable monetary easing.



Sources: RichesFlores Research, Macrobond

In the developed countries, where monetary leeway is hard to come by, the disinflation movement's effects will probably operate on long-term interest rates instead. According to our model for calculating U.S. 10-year interest rates, which takes into account underlying inflation in the U.S. as well as the global inflation rate, an additional 30-40bp drop in long-term interest rates could take place if global inflation falls to 2.5% before spring. As a result, there is potentially room for a drop in T-Bond yields to levels of less than 2%, if such a scenario were to materialize.

Regardless of developments on the American economic landscape, the risk of seeing the T-Bond trajectory change course in the near term is very limited indeed. This also applies to the euro area where the economic situation and forthcoming ECB intervention leave little room at all for a rise, however modest, in long-term interest rates. The prospects of the bond markets changing direction seems to be fading into the sunset...

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