The Telegraph

US inflation rears its ugly head as global cycle nears danger zone

- AMBROSE EVANS-PRITCHARD

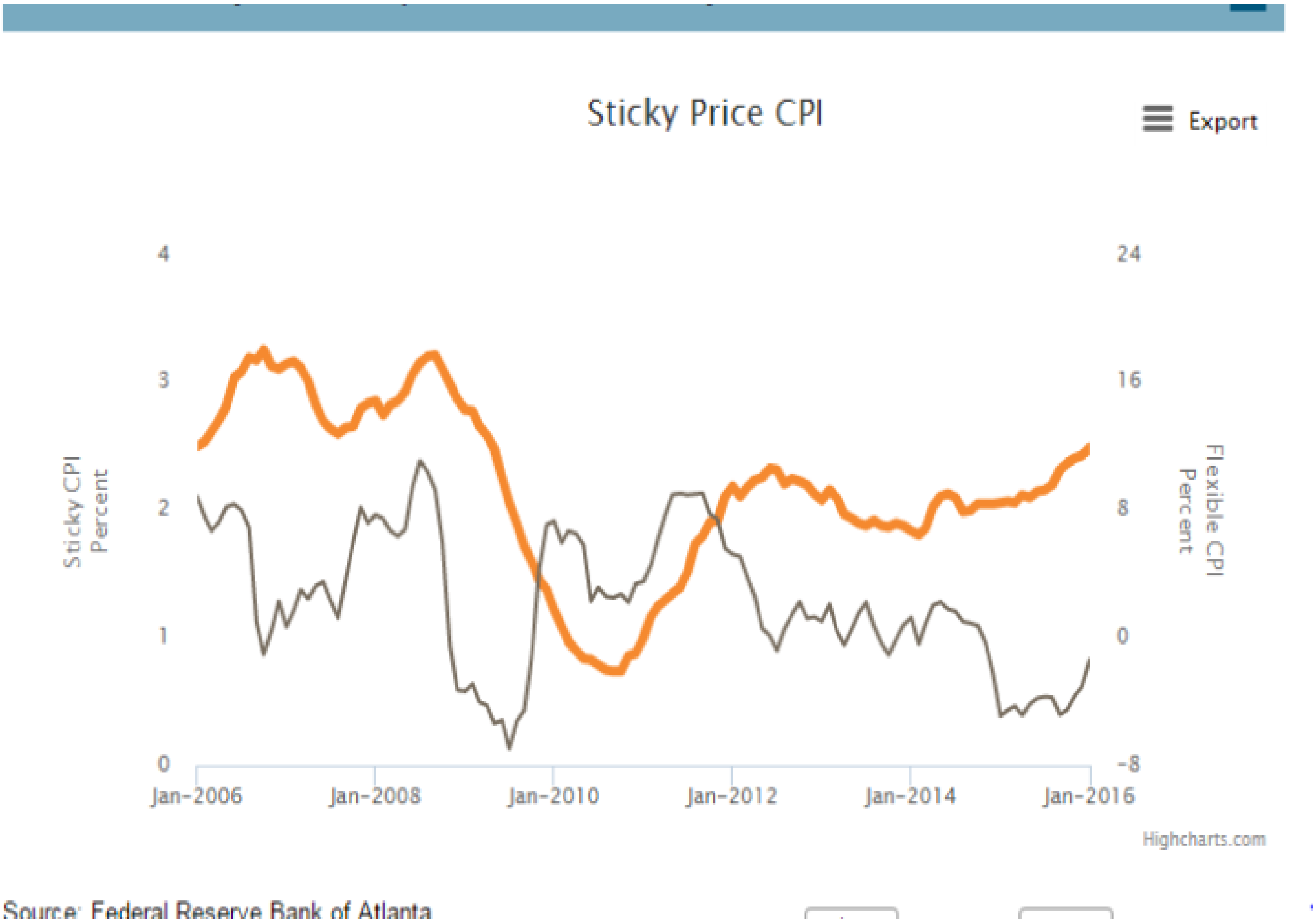
The trigger for the next global recession is at last coming into view after a series of loud distractions and false alarms.

The Atlanta Federal Reserve's gauge of "sticky-price" inflation in the US soared to a post-Lehman peak of 3pc in February. This index is a 'pure' measure of core inflation - the underlying story once the noise is stripped out.

The Cleveland's Fed's 'median consumer price index' jumped to 2.9pc, with big rises are in medical services, housing rents, car insurance, restaurants, hotels, women's clothing, jewelry, and car hire. This is the long-feared inflexion point we all forgot about in those halcyon days of deflation, now just a fond memory.

The Fed's veteran vice-chairman Stanley Fischer is itching to tighten. "We may well at present be seeing the first stirrings of an increase in the inflation rate," he said in a portentous speech last week.

Every major downturn since the First World War has been caused by the Fed, determined to snuff out inflation as the credit cycle matures. Expansions rarely die of old age. They are killed.



Sticky-price CPI measures underlying inflation CREDIT: ATLANTA FED

There may have been other factors in each historical episode - the oil shocks of the 1970s, or the first Gulf War in 1991 - but the Fed has been the determining catalyst each time.

Mr Fischer could hardly have been clearer. He spelled out why the 1970s 'Phillips Curve' trade-off between unemployment and inflation is alive and well, and an implicit warning that prices could soon off take since the labour market is clearly approaching the electric fence of Milton Friedman's NAIRU (non-accelerating inflation rate of unemployment).

The economy created 242,000 jobs in February. The broad U6 unemployment rate has dropped to a cycle-low of 9.7pc. The willingness of workers to switch jobs - the 'quit rate' - has surged since September and is back to 2008 levels.

Higher wage demands will follow as surely as night follows day. The Fed will not raise rates this week with so much fog still in the air. Half the world is in a sulk, the ISM manufacturing gauge still below the boom-bust line of 50, and US retail sales slipped again in February.

Broad U6 unemployment

But be careful. John Williams from the San Francisco Fed says that under any definition of the Taylor Rule - used by central banks to calibrate policy and the output gap - there should be an "immediate increase in rates".

It not happening yet because doves first want to see the "whites of the eyes" of coming inflation. That is hardly a comfort.

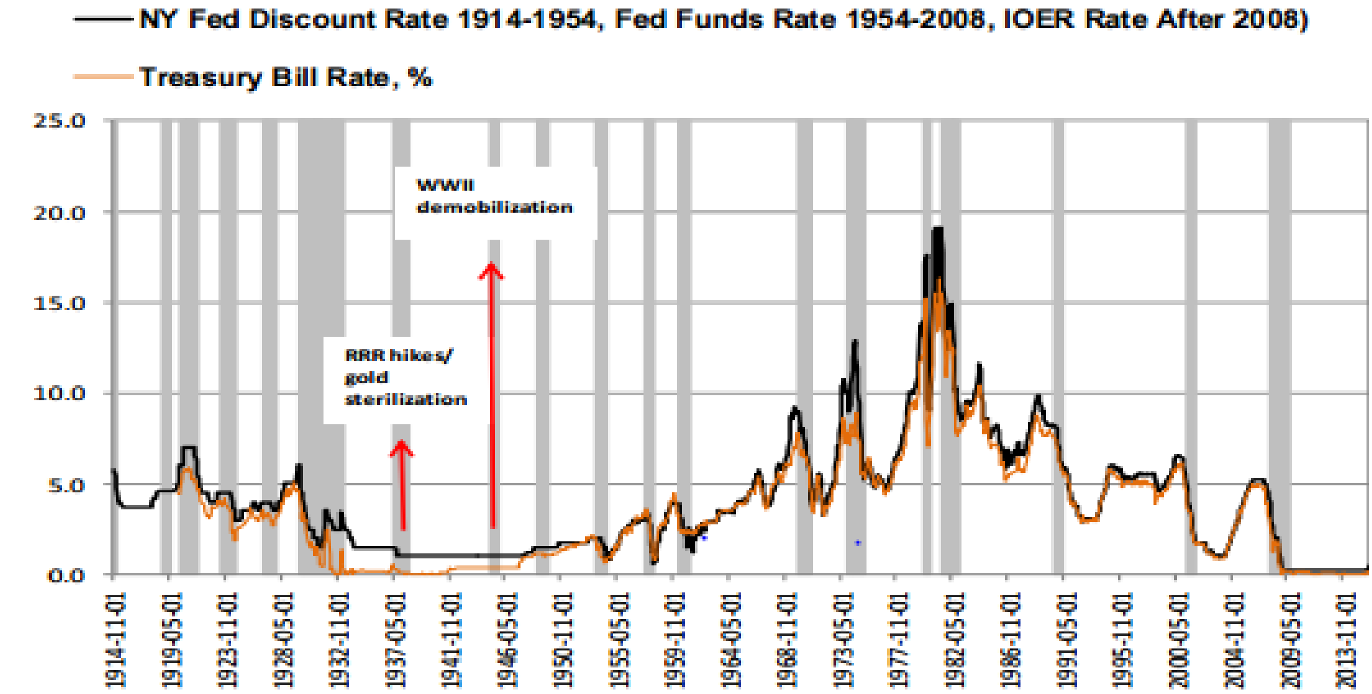
Markets are still dismissing hawkish talk as bluster, betting that the Fed will not be able to raise rates four times this year as loosely implied by its own 'dot plots'. Futures contracts are pricing in just a 30pc chance of two rate rises.

Michael Darda from MKM Partners said markets are remarkably complacent about the Fed, and warned against trying extract much more profit from a tired rally.

"Our working assumption is that we are likely in the last year to year-and-one-half of this cycle. On average, equity markets tend to peak about six months before a cycle peak going back to 1929," he said.

Yet we are in uncharted waters, and exactly where we stand on the monetary spectrum is a hotly disputed subject.

"We simply do not see any build-up of late-cycle pressures. We estimate that the US is about two-thirds into the current cycle, and have pencilled in the next downturn around 2018-19," said Societe Generale in a new report.



ource: Bloomberg; MKM Partners

The rise and fall of US interest rates

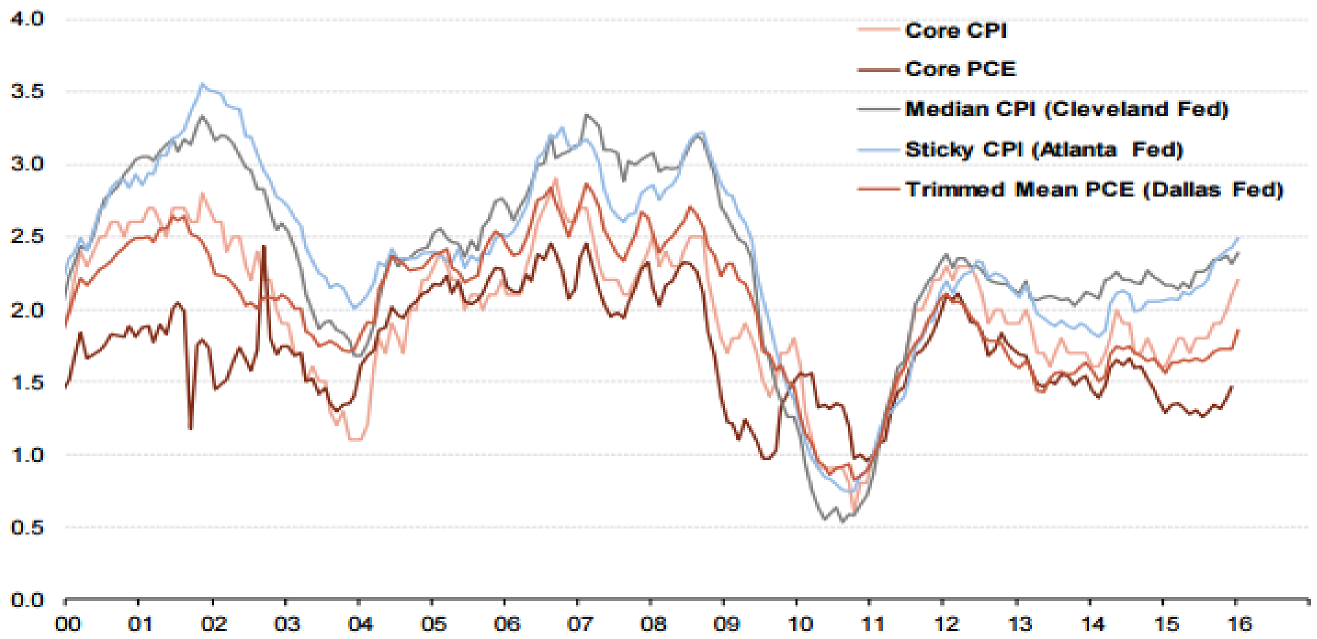
The oil crash has muddied the waters and disguised the build-up in price US pressures. This distortion will disappear by July or August. The 'base effects' of oil could then start to kick in the other way, pushing up headline inflation as crude recovers to $50 or $60 by the end of the year - a plausible hypothesis as output rolls over in Russia, the North Sea, Nigeria, Algeria, and the US shale belt.

A bizarre feature of the market panic over the New Year was the widely-held belief that cheap oil would push the world over the edge, setting off mass defaults across the energy industry and a banking crisis as CoCo bonds plummeted.

"The stories we were telling each other in markets in January and February involved wild exaggerations and the narrative was heavily inspired by the 2008-2009 financial crisis," Torsten Slok from Deutsche Bank.

Let us be clear about one point that has caused huge confusion. The political decision by Saudi Arabia and the Gulf states to flood the world with crude is a textbook case of a 'positive supply shock', and therefore a net plus for the rest of us.

Chart 4.10 US core inflation metrics climbing higher



Source: Haver Analytics, SG Cross Asset Research/Economics

Rising core inflation in the US

The richest oil states are not cutting spending by much. They are drawing down savings from the reserves and sovereign wealth funds. The overall effect amounts a worldwide fiscal stimulus worth almost $2 trillion over the last year. Yes, the oil and gas industry is in trauma, but the 'good' side of the energy equation is filtering through with a delay.

Nor is China collapsing. No devaluation is under way. The yuan has been stable in trade-weighted terms for seven months. The Bank for International Settlements says much of the capital outflow from China has been to pay down dollar debt and is largely benign. Foreign reserve depletion has subsided in any case.

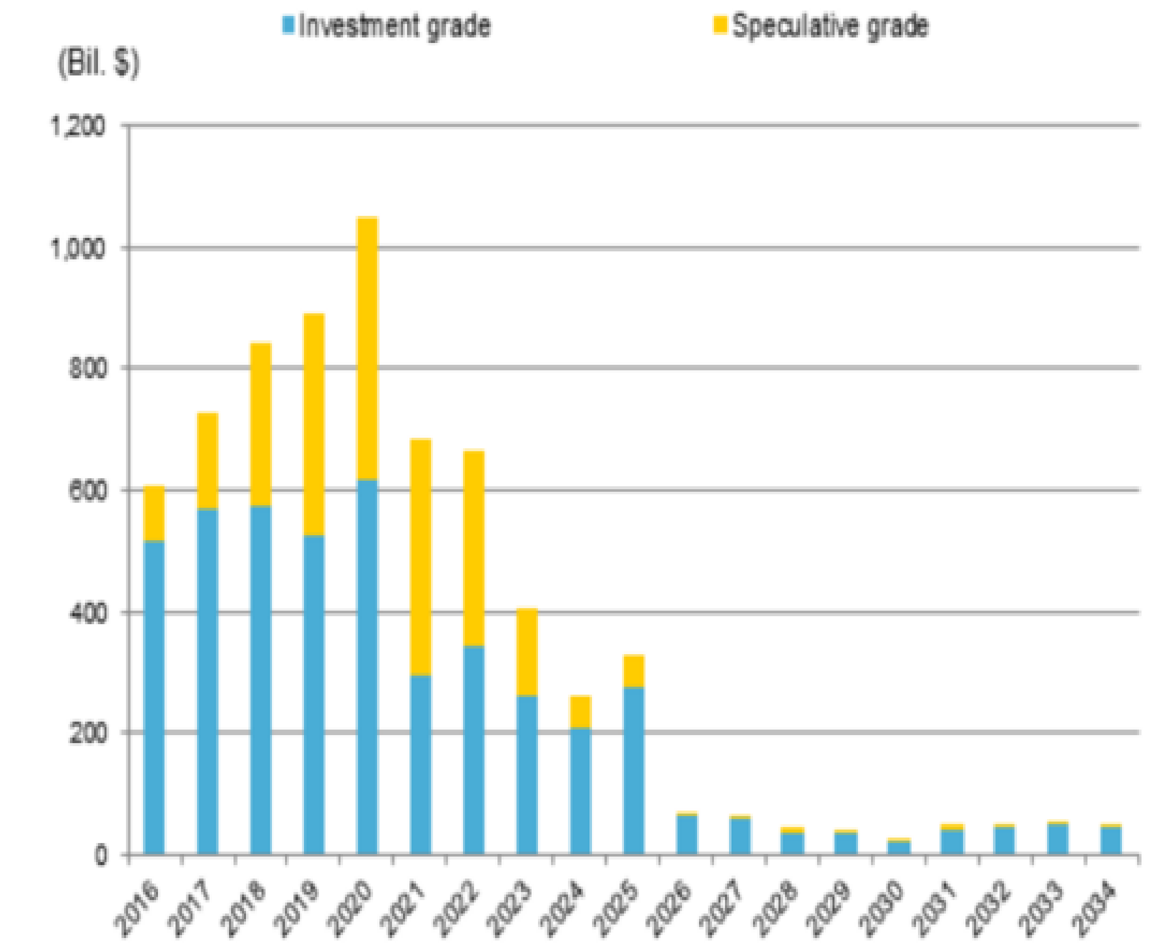
The Chinese economy bottomed in mid-2015 and has been slowly recovering. Credit is again growing at unhealthy double-digit rates. The Communist Party has put off the day of reckoning for another year by pulling the levers of stimulus. When that moment comes, it will be even harder to deal with, and by then the Fed will be on the war path making everything harder.

Nobody knows how much US tightening the world can bear. You could argue that the Fed has already carried out a full rate cycle by winding down quantitative easing and driving up the dollar. Its own Wu-Xia shadow model suggests that this alone equals 13 rates rises since early 2014.

What we know is that dollar debts outside the US have reached a record $10.8 trillion, and as the BIS warns, borrowing costs across the world are likely to rise in lockstep as the Fed lifts rates even if debt is in local currency.

Within the US itself, companies have been tapping loan markets to buy back their own shares at a pace comparable to the pre-Lehman blow-off. Diane Vazza at Standard & Poors says $4.1 trillion of US corporate debt will come due between 2016 and 2020, with eye-watering volumes of junk debt maturing as soon as next year.

We have a dollarised global system with an average debt ratio that is 36 percentage points of GDP higher than it was at the peak of the last cycle, and that has never been so leveraged to the actions of the Fed. It is not cheap oil you have to worry about. The moment of maximum danger will come when oil recovers.



Note: Data as of Dec. 31, 2015. Includes bonds, loans, and revolving credit facilities. Foreign currencies are converted to U.S. dollars at the exchange rate on the close of business on Dec. 31, 2015. Source: Standard & Poor's Global Fixed Income Research.