Why some fund managers aren't worried about inflation ... yet

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The signs are all there. Friday's U.S. jobs report showed average hourly earnings posting the largest gain since June 2009. More broadly, government spending is increasing, Treasury rates are jumping, the dollar is sinking, the labor market is tightening and U.S. overnight interest rates are still at historically low levels.

In years past, these have all been warning signs of looming inflation, and some analysts are starting to ring the alarm.

Part of the worry analysts and economists have is that resurgent inflation hasn't been a major concern for years. Valuations of the stock market are not priced for higher inflation and accompanying higher U.S. interest rates.

Jim Paulsen, chief investment strategist at the Leuthold Group in Minneapolis, sees the inflation rate heading to 3% this year. While that's not extraordinarily high, it's well above the expectations of the Federal Reserve and of most market participants.

“There is a complacent attitude that’s at risk of being shocked when we do see some inflation,” Paulsen said in a phone interview. He lists a surprise increase in nominal inflation as his “primary risk” for 2018.

An inflation spike could trigger repricing in stocks and bonds

A surprise in the range of 3% inflation could lead to a major sell-off in stocks. Higher U.S. inflation reduces the value of corporations’ profits, making an equity market that is already at high values by historical metrics look even more so. The S&P 500’s current price to earnings ratio is just under 23, a hair below its peak during the financial crisis in 2009.

The Federal Reserve Bank of Atlanta’s GDP Now tracker shows expectations of 5.4% gross domestic product growth in the first quarter this year. Its year-ahead expectations survey shows business leaders see only 2% inflation – a combination that is highly unlikely.

Rising inflation could also spur the Federal Reserve into raising U.S. interest rates faster than expected. The Fed is currently expected to raise rates three times this year, and its predictable, slow pace over the past two years has been a key driver of the stock market and economic growth.

A recent survey of money managers by Bank of America-Merrill Lynch found they viewed an inflation-inspired bond crash as the biggest danger to financial markets.

“If you take away certainty of moves and gradualness and introduce new risk, certainly the equity market has to reprice itself,” said Larry Hatheway, chief economist and head of multi-asset portfolio

solutions at asset manager GAM in London via telephone. “If that’s the case, people say we’re probably going to get a recession 2019 and 2020. It doesn’t take a lot. Just a relatively modest change in inflation could cause a broad market repricing.”

Why some fund managers aren’t worried

While Hatheway’s inner economist worries about inflation, as a fund manager he remains largely bullish on the market. Fund managers reached for this story generally agreed, telling Yahoo Finance they don’t see inflation becoming a problem.

In fact, some say that absent a major shock – like a world war – inflation won’t be returning to the United States any time soon. The personal consumption expenditures index, long thought to be the Fed’s favored measure of inflation, has consistently failed to reach even the central bank’s target of 2%.

“There are very good reasons inflation expectations are as low as they are,” said Arvind Rajan, head of fixed income global and macro for PGIM in New York.

Rajan also said that rising wages have not yet passed through to prices. He also pointed to the lingering impacts of globalization and technological development on decreasing costs and the power of companies like Amazon to consistently de-incentivize other businesses from raising prices. That’s caused firms around the globe to lose much of their pricing power, holding down costs.

Other fund managers including Barbara Reinhard, managing director and head of asset allocation at Voya in New York, say that despite the low headline U.S. unemployment rate, the country has an aging population that is working and spending less, reduced

labor force participation and high number of job openings. Many Americans also are working less hours than they'd like to, meaning companies can add workers without major increases to wages.

"You would need significantly faster growth without any lift from productivity to say inflation was going to [rise significantly]," Reinhard said. "I think it's an extreme left tail event that has extremely low probability of happening."

Beware limited resources

Still, **Bernard Baumohl, managing director and chief global economist at the Economic Outlook Group in Princeton**, New Jersey, says investors shouldn't be so sure. As the world economy grows there's more competition for labor, commodities, goods and services, which eventually has to show up in prices.

"The reason why we do see inflation pressures picking up is because at some point you're going to reach the limits in terms of your resources," he said. "Ultimately those who argue we're going to continue to see inflation remain under 2% are missing the bigger picture. The Phillips Curve hasn't completely disappeared, you just have to look at it from a global scale."

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