
Inflation or deflation? It's a toss-up

By Kerry Pechter *Fri, Oct 4, 2013*

It's hard to say whether the combination of aging populations, low interest rates and high government debt will lead to deflation or inflation, says AXA Investment Managers. But in the short term they recommend a higher equity allocation, according to a report at IPE.com.

AXA Investment Managers say pension funds must be aware of the widening "duration mismatch" in their portfolios as a retiring membership clashes with the prevailing low-yield environment, IPE.com reported.

In a paper on longevity, AXA said two trends - the low-yield environment and retiring baby boomers - were "superimposing" themselves on the coming problem posed by a globally aging population.

The research observed that the instinctive choice of many on retirement was to invest in fixed income, an approach at odds with current bond yields.

"In order to pay additional annuities in the short term, pension funds need to invest in higher-return assets such as equities or real estate," it noted. "With increased pressure on the short-term horizon of their liability and a chase for yield that delivers in the longer term, pension schemes are caught in a duration mismatch that keeps widening as the new demographic steady-state, post baby-boom is getting closer.

"So changes in mortality tables and structures of age pyramids imply radical changes in the temporal profile of liabilities for public and private pensions alike, which must adapt their [asset-liability matching] strategic choices accordingly."

The research recommended increasing equity exposures to "satisfy the need for higher shorter-term yields. Tilting the balance towards equities would hopefully compensate for depressed bond yields. This is a noteworthy move, as it departs from an old habit," the paper said, noting UK pension funds are pursuing that strategy.

A rising dependency ratio in countries could lead to deflation among the developed nations, AXA added, pointing to past experience of rising old-age ratios in Japan.

"But an aging population could well turn into inflationary forces if an unsustainable rise in government debt led to its monetization," it added. "When old-age dependency ratios reach the levels forecast by the UN in only a decade's time, this would mean inflation next to zero or even turning into outright deflation."

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