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Get Ready For Inflation

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A key issue for wealth managers for the near to medium term is whether the large injections of money into the economy by central banks will, as has sometimes happened in the past, presage an acceleration in inflation pressures. If so, wealth managers need to start thinking now about how to protect their clients' assets from the ravages of rising prices, since even a supposedly low rate can take a large bite when compounded over a few years. Jerry Haworth, director of the firm 36 South Investment Managers, examines the inflation threat.

The starting point for this debate has got to be the area where it seems even the odd pre-eminent economist doesn't get it.

Probably the biggest logic error made today is the premise that inflation won't occur while there is "capacity" in the economy. Zimbabwe, while extreme, is a good example of nearly 100 per cent excess capacity in the "real" economy and hyper-inflation in the "financial" economy. This is classic "stagflation" as was seen in the 1970s.

Furthermore, inflation and deflation can co-exist within an economy. The reported figures just show the net inflation/deflation. What parts of the economy are inflating and what parts are deflating are critical to investors because it determines whether there is net wealth creation or net wealth destruction in the economy.

Conundrum

This creates a conundrum for wealth managers. How to position a portfolio given the propensity of the economy to display signs of both stagnation and inflation? What parts of the economy are inflating and what part are deflating? Furthermore, if these forces are benign, why even worry?

We believe these forces are not benign. Significant stagflation is around the corner and one has to be proactive.

Why do we believe this?

The Past

The economy built up extravagances over the past 30 years, which are now subject to massive deleveraging forces as the previous credit-fuelled boom in asset markets unwinds. This would have resulted in significant deflation if left unchecked, so the government's response has been to aggressively lower interest rates and increase the money supply, both of which are inflationary. This will not necessarily stop the deflation, as has been the case in Japan over the last 20 years. So we will probably have significant inflation and deflation, in the worst possible combination. With respect to positioning a portfolio, one must first look in the rearview mirror to understand the road ahead.

Low inflation over the last 30 years “masks” what really went on. We had significant financial asset inflation and significant deflation in prices of goods - “gladflation” if you like. Our investments (i.e. shares, property etc) went up as easy credit fuelled price rises in most asset classes but the price of real goods remained stable or went down mainly because of productivity gains i.e. globalisation and the internet. We slept and grew rich. Our “wealth” grew as financial asset prices grew faster than real asset prices.

The Future

Now we have the “bad” inflation on the horizon, if not here already. Prices of real goods and services prices will go up faster, much faster, than our financial asset prices. Our ability to pay for goods will diminish. We grow poorer in our sleep. Imagine going to the bank every day and finding your bank balance had reduced whilst the price of your normal groceries goes up every day. That is the future...and it should come with a wealth warning label.

If you are an investor what is relevant is the relative rate at which inflation/deflation is running in the real economy verses the financial economy. Wealth creation happens when our financial assets inflate faster than the real assets we wish to purchase in the future. Wealth destruction happens when real asset prices rise faster than financial asset prices.

And when this happens against a backdrop of a stagnating economy, all effects are exaggerated.

We believe we are going to see stagnation with inflation – the wealth destructing kind.

If this comes to pass, what will happen to a traditional portfolio i.e. property, bonds and equity?

A portfolio of financial assets will generally be corroded by this kind of stagflation until such time as yields on all assets correctly reflect inflation expectation. If inflation is 20 per cent, earnings yields should be as high to rate as an attractive relative investment - otherwise people will sell their investments and just deposit the money at the bank and earn 20 per cent. The problem comes in during the process of adjustment. A share with a price/earnings multiple of 20 implies an earning yield of 5 per cent. In order to have a 20 per cent earnings yield, the PE will have to drop to 5 which is a 75 per cent drop in price. It will be the same story for a portfolio of property.

Investors might be spared some pain if governments hold interest rates lower than inflation. Investors will be “herded” out of cash and into the stock market and property, not because it is a good stagflation investment, but because of the dearth of alternatives. This policy will destroy wealth at a slower pace because these asset markets yields won’t keep up with inflation. They will ultimately need to correct down or “stagnate” for years while earnings yields increase to reflect the higher yields required.

All financial assets whose value is determined primarily by yield or earnings will find their price going down initially: property, stock market, bonds and money market.

When the market rates and yields reflect inflationary expectations, they will track inflation from that point. So if the earnings yields are 20 per cent and inflation is 20 per cent, the stock market should go up 20 per cent a year on average going forward.

Investing in this environment

In order to protect their portfolios investors should consider the following:

Gold bullion – gold will hold its value in inflationary times as investors run for real assets. There are few true real assets which can be stored for any length of time and are small enough not to be inconvenient to hold. Gold will hold its value in deflation as well so both bases are covered.

Cash – initially, whilst the asset markets correct to reflect the higher yields required, being out of both the stock markets and the bond markets is not a bad idea. Once these assets have a decent yield, they can be re-bought.

Commodities/real assets – real asset prices should move higher. The de-leveraging of the financial economy might have some initial negative impact but they are still worth holding.

Debt – pare down debt initially as there are precious few assets to buy to shield you even at these low interest rates.

Volatility Hedge Funds –JP Morgan was once asked what the markets would do that year. He replied: “they will fluctuate!”. There will be volatility in the near future as investors play musical chairs with their portfolios. Volatility funds will therefore do well in this environment.

In summary, there seems to have been a regime change in the economy. There is significant stagflation on the horizon. Wealth creation will be replaced with wealth destruction. What worked for the last thirty years will not work going forward. Get your asset allocation wrong and your wealth could be decimated.