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Global Overview: Inflation as an Investment Tool

The term "inflation" generally has a bad connotation, but so does "deflation". In the real world, prices rarely stay the same for long. So does that mean things are always "bad" since prices are almost always either rising (inflation) or falling (deflation)? Obviously, there is more to be considered than just a general rise/fall in prices. "Some" inflation is generally considered a good thing, and "too much" is to be avoided, but where is the dividing line between the two? "Deflation" is almost always considered a "bad" thing, but then why do we spend so much time looking for "deals" and get so excited when we get a newly lowered price (deflation)? To further add to the confusion, why do we envy the higher GDP growth rates of some other countries and lament "why can't we be more like them?" when those countries have inflation rates that are very high as compared to ours? Is there an optimal "cost/benefit" relationship between inflation and economic growth?

The Last 100 Years

Despite multiple wars, natural disasters, civil protests, pandemics, recessions, a "Great Depression" (resulting in significant deflation), an energy crisis (at least partially responsible for a period of "hyper-inflation") and other significant financial crises, the U.S. has enjoyed a significant amount of economic progress over the past 100 years. During that time inflation has averaged about 3%, but averages can hide a lot of variation. From 1917-1920, inflation ranged between 14 and 18%. From 1930-1933, it ranged between -2% and -10%. From 1978-1981, it ranged between from 6% and 11%. These periods of hyper-deflation/inflation are always accompanied by major economic episodes of turbulence and uncertainty.

A country's inflation rate can be thought of a bit like a heartbeat in terms of an indication of health. The range of a healthy person's heartbeat tends to range between a broad range of around 60-160 beats per minute (bpm), but sustained heart rates well below/above this range can be a sign of trouble. During periods of intense exercise, "spikes" in a healthy person's heart rate to 180-200 are not particularly worrisome, but a resting rate below 60 bpm by the same magnitude (20-40 bpm) is usually a cause for concern except for particularly well-conditioned athletes. The same tends to be true for inflation rates. Most healthy economies tend to have inflation rates between 2-4%, but higher rates of 5-6% are not unusual or problematic (especially for "younger"/faster growing economies, much like with humans) provided they are not in place for a protracted period of time. On the other hand, sustained inflation rates approaching 0%, or deflation (negative inflation), are almost never a good sign.

Why is a little inflation a good thing?

Both inflation and deflation can impact an economy's performance, but generally speaking, some inflation is more beneficial than deflation for a variety of reasons:

1) Prices are primarily determined by supply and demand. If prices are rising, this generally means supply is not quite meeting demand. This can lead to desired economic activities like capital investment, hiring, increased work hours/overtime pay and job stability. On the other hand, if prices are falling because supply is too large, the reverse effects can result and in certain cases, a recession/depression can ensue.

2) When product/service prices are rising due to strong economic activity, real asset prices tend to also rise. In many cases, these assets serve as collateral for loans. When economic activity is strong, and bank loans are well secured by reasonably liquid collateral, credit losses are low and banks are more inclined to provide loans to worthy borrowers. If asset prices are falling, economic activity is also likely slowing and bank credit losses begin to build and credit becomes scarce. At that point in a "credit cycle", even financially strong borrowers can be challenged in securing credit and that further erodes potential economic expansion.

3) Rising values of real assets, such as homes, tend to reinforce consumer/investor confidence which in turn supports economic activity. Also, many small businesses are formed via capital raised from second mortgages. When home prices fall, budding entrepreneurs may not only lack the needed confidence to start a new business, but they also may find it difficult to tap the equity in their homes if home values are depressed and/or falling since creditors will be concerned about the quality of the collateral that would back the loans they issue.

Is deflation always a bad thing?

A "general" decline in asset values is oftentimes not a sign of a good situation if it is being fueled by a softening economy, but declining prices related to productivity increases, innovation, international trade or other positive developments can lead to higher standards of living (i.e. technological advancements, pharmaceuticals, improved logistics, communications, data collection & analysis, etc.).

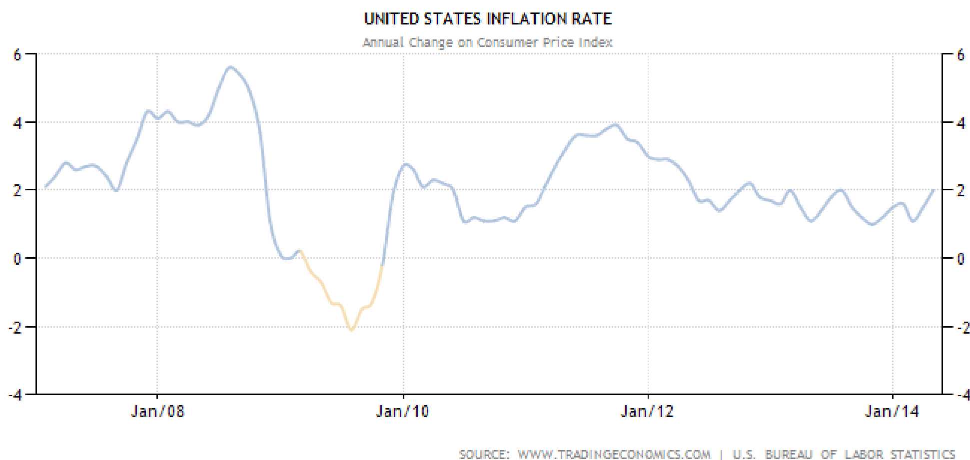
It just all depends…

Both deflation and inflation can be a good or bad thing depending upon the factors causing the change in prices, the degree of the changes and the starting point from which the price changes are initiated. We will now review some of the major economies of the world and see what this looks like in practice.

United States of America: Low Inflation, but Insufficient Economic "Momentum"

The inflation rate of the U.S. has been near an "ideal" zone. It has been staying relatively steady between 1.5-2.0% for much of the last 4 years with the exception of some readings closer to 3-4% during the last part of 2011. The Federal Reserve would probably be very pleased with a 1.5-2% inflation rate, but as the below chart shows, there was a slight drift downward towards the 1% level prior to this week's report. The Fed is more concerned about the prior downtrend towards a potentially deflationary environment because economic activity has been sluggish as indicated by economic measures such as employment, capital investment and

construction activity. If these measures were more robust, then the current low level of inflation would be less worrisome and it would be something akin to economic "nirvana":



Please Note: Much has been made about the U.S.'s recent 0.1% GDP growth rate during the first quarter. As you can see in the above chart, the "annual" GDP growth rate was 2.3%. The reported 0.1% figure is a sequential "quarter-on-quarter" annualized statistic which tends to amplify seasonal "noise" (like the recent severe winter weather) despite efforts to adjust for such seasonal variations.

<u>Brazil: Improving (but low) GDP, but Trend in Inflation is at Major Inflection Point</u>

Brazil should be growing 50-100% faster than the U.S., but it has suffered from high inflation, weak commodity export prices and slowing demand from China. Its GDP growth has begun to establish an upward trend, but the progress the country had made to get its inflation rate back down to 5% almost two years ago has been partially given back with a recent spike back up to over 6%:

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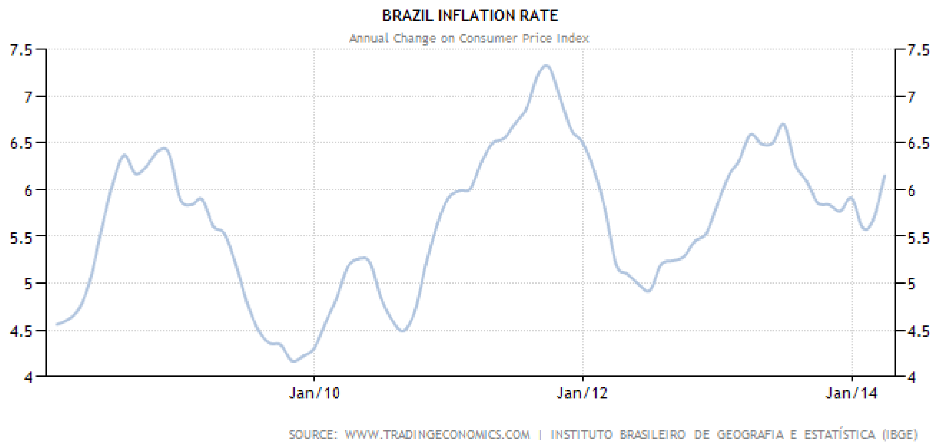


India: Stabilizing GDP Growth, but Inflation Remains a Problem

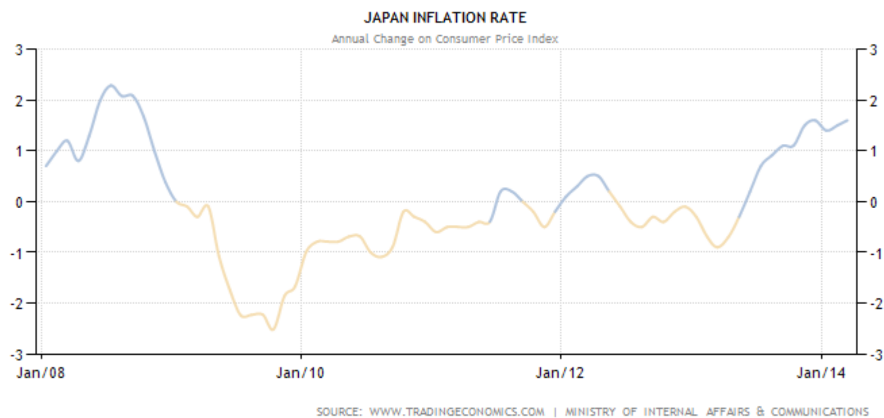
India's GDP growth has stabilized around 4.5% (well below China's 7.5%), but its inflation rate of over 8% (2-4 times higher than China's) remains a stubborn problem. The country began holding national elections last month and the official results will be available soon (there are around 800 million eligible voters in India and many jurisdictions which is the source of the delay). The election results, as well as the newly elected party's future economic policies, are major factors in whether one might consider investing in India, but even if the policies are very sound and effective, it will take several more quarters of data to support the notion that the country's inflation rate is going to be brought down to a level where continued economic prosperity is a high probability outcome:

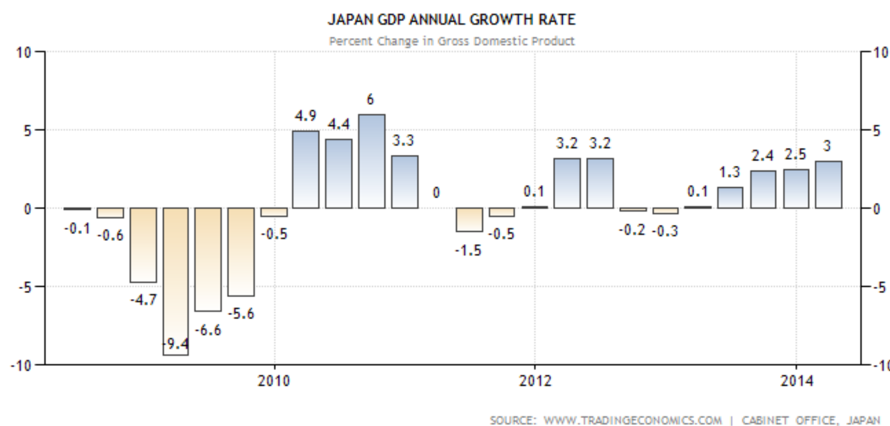
China: Stabilizing GDP & Stable Inflation

The economic statistics that come out of China are oftentimes criticized for either their suspected inaccuracy and/or incompleteness. Despite the influence that the Chinese central government may play in the reported figures, the dramatic deceleration in China's GDP growth is not something that they have done a very good job of hiding. To a certain extent the slowdown has been self-inflicted as the Chinese government has tried to shift from a government-controlled capital investment and export driven economy to one that is more consumer-oriented (as are most developed economies). Inflation was running very high in China in 2008 and late 2011, but it has stabilized around a 2-3%. If credit reforms and efforts to reduce real estate speculation can continue without damaging what appears to be a leveling out of GDP growth around 7.5%, then China may become an attractive place to invest in again after almost a three year period of adjustment:

Japan: Inflation is Moving in the Right Direction and GDP is Showing Some Acceleration

The inflation rate in Japan is almost at the same level as in the U.S., but unlike the U.S., the inflation rate is in a more established trend upwards. This is a good example of how it isn't just the level of inflation that matters, but also the trend and where the rate was in prior quarters. Japan has struggled with intermittent deflation for the past couple of decades and it has resulted in erratic GDP growth, but the last three quarters have shown grown with each quarter a bit stronger than the last:





Euro Area: Deflationary Concerns are Significant, but Recent Inflation and GDP Growth Data are Promising

The Euro Area is "flirting" closer to deflationary levels than in the U.S., but the rate of ***disinflation*** (the decline in the rate of inflation) is slowing and the rate of inflation has begun to show signs of stabilizing between 0.5-0.8%. The continuation of this stabilization is likely to be supported with the recent return to very moderate, but positive, GDP growth. Mario Draghi, the President of the European Central Bank (ECB), has been hinting strongly of late that he supports the introduction of more accomodative monetary policy and the likelihood of this has increased as Germany's Bundesbank has been less vocal in its traditional opposition to such policies:

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Strategy Implications

1) For much of the last 3-4 years, the U.S. has been clearly the best place to invest because we had one of the most accommodative fiscal and monetary environments, but both of those supports have begun to be reduced/withdrawn as the growth in Federal spending has slowed significantly and the Federal Reserve has begun to reduce its "quantitative easing" initiatives. We have had an overweight in U.S. equities for the past few years, but we are steadily moving towards an underweighted posture.

2) The most promising economic region per the above inflation/GDP growth rate analysis approach is the Euro Area because it has shown the best combination of low (but positive) inflation and it is showing distinct signs of exiting its "double-dip" recession. For over a year we have been building allocations to this economic region and we are currently at what we would consider a maximum allocation to the region's related equity investments.

3) Japan is a close second to the Euro Area in terms of investment attractiveness due to its government's accommodative economic policies, low inflation and its recent return to positive GDP growth, but its long-term economic struggles are not distant enough in the past to have full faith in the reliability in the country's economic recovery. We have a moderate allocation to Japan in our more globally diversified strategies, but we are not yet willing to make an outsized allocation until more evidence is provided to support the notion that current trends are sustainable.

4) Brazil is probably the country we most want to add to our international allocation due to its historically high GDP growth rate, favorable demographics, rich natural resources and export potential, but we will

look for further progress in the country’s efforts to bring the inflation rate back down below 6%, and preferably closer to a 5% or lower level.

5) India has the 4.5% or so GDP growth rate that we feel Brazil could achieve, but its 8%+ inflation rate is well above that “180-200 bpm heart rate” analogy that we described as being in the general range of “healthy” for a person under periods of significant physical exertion. Given the significantly higher inflation rate of India vs. Brazil, we are likely to invest in Brazil before India, but changes in the political winds of both countries have historically been major determinants of the efficacy of their respective economic policies so the landscape can change rather quickly in either direction.

6) China has the inflation rate we like to see in emerging market countries (below 5%) and the 7% GDP growth rate is very attractive (though significantly reduced from the 10%+ of years past). However, the questions on every international investor’s mind is: “Is 7% GDP growth the “new normal” for China, or is it 5-6%, and do valuations fully reflect the credit problems that remain in the real estate sector and elsewhere?” The answers to these questions are generally not truly knowable with a high degree of certainty until well after the point that an exceptional buying opportunity has passed. If the Chinese economy and capital markets continue to stabilize, the Chinese government continues its reforms and significant signs become more visible that the credit fragilities have been identified and “ring-fenced”, then we may seek some moderate exposure to Chinese equities (for the first time in almost 3 years) within the coming year.

About a year ago, I spoke to the potential for an episode of “ugly synchronicity” as the major economic regions began to grow their economies once again (i.e. Euro Area & Japan) and/or stabilize their GDP growth rates (i.e. China & Brazil). This “synchronicity” has occurred and it has been “ugly” in terms of volatile economic data, uneven growth and widely varying levels of price stability with some countries nearly dissolving in an “acid bath” of deflation or “exploding” in a blaze of hyper-inflation. Despite all of these cross-currents, the global economy does appear to be healing and we feel it is warranted to upgrade the “synchronicity” of the global economic recovery from “ugly” to “semi-pretty”, but as always:

“Look to the Future, be Optimistic…but Hedge.”

(We want to keep these commentaries brief and focused so as to provide a good “information-to-text-length ratio”, but if you have specific questions/topics you want me to address, please let us know.)

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