View from the Bridge – 1st October 2020

Deflation / Inflation? What's next, what's the answer and tales of the barbarous relic.

Last month we laid out the case for inflation but before we look at ways of insuring against such an outcome we need to accept that we are staring down a possible deflationary bust before we start seeing a general rise in prices.

"Money that costs nothing is worth nothing" – we live in an environment of zero interest rates plus or minus a basis point or two, higher in the US and lower in Europe, and this tells us that the expected return on any investment that requires funding is going to be very low too. This then translates into anaemic GDP growth at best, which just prolongs the deflationary cycle.

Adding more debt just makes it worse as it is then incumbent on the central banks to keep the interest rates low so that government can afford to pay the interest on the burgeoning debt pile; and down the spiral we go. Since the Great Financial Crisis we have added four times more debt than we have seen in increased output! $4 of debt for $1 of growth.

Assume that none of that growth was spent other than going towards repaying the debt and you can begin to see the problem. For corporates it is just as bad, if not worse, as the government, at least technically, can't go bust, whereas they can and, in the present environment, almost certainly will and in much larger numbers than currently envisioned. That will be the deflationary "bust". The Fed can provide liquidity to the corporate bond market, but they can do nothing about insolvency.

So in the very short term high quality debt ie sovereign debt will remain the default risk off investment but how much duration do we want to take? With markets at least thinking about inflation long duration bonds aren't sensible and even 10 years maybe too long. The Bank of England is talking about the mechanics of negative rates. They mean cash not bonds but lower bank rate usually translates into lower bond rates and indeed UK 2 and 5 year gilts are already yielding sub-zero. Maybe cash is the best risk off asset right now but only in the short term.

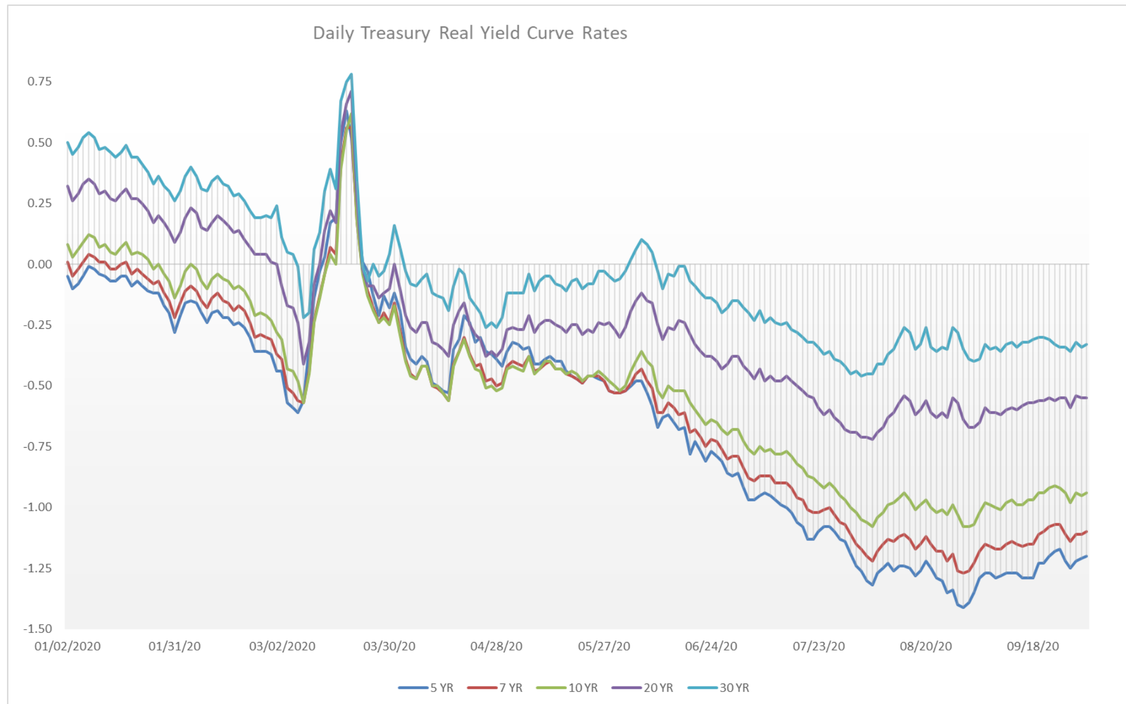
Corporate bond yield spreads against Treasuries are widening; not dramatically but heading the "wrong" way nveretheless to make them a viable option. What is interesting is that the Fed have started accumulating TIPS (Treasury Inflation Protected Securities) which has driven up the forward expected inflation rate. They really want inflation to rise which means the cost of rep[aying debt goes down; the opposite happens in a deflatioary bust which they don't want to happen.

Maybe they think they can control inflation. They can of course but only if they raise interest rates to levels that would finish any chnace of an economic recovery so they will continue printing and look to introduce yield curve control (YCC). They can do this by purchasing sufficient quatities of Tresuries to keep the yield down but they will almost certainly limit this to short dated securities.

They may allow the long duration issues 20 year plus to go to a higher yield to keep the banks in business. Banks can borrow at low rates for the Fed and buyer higher yieldiing long dated issues and they do this with leverage; almost sounds like free money doesn't it? Of course this is all conjecture but bonds really don't provide sufficient returns for the level of risk

If inflation is coming then what will provide protection. Traditionally precious metal, gold and silver, have performed that function. The main criticism levelled against the metals is that they pay no income but in a world of negative real yields gold at a yield of zero looks pretty attractive. The movement in real yields is one of the key data points to watch.

Recently with bond yields starting to rise real yields have started to rise and unsurprisingly we have seen a sell off in gold from the August peak at $2075. Real yields bottomed in August too.



It is quite feasible that gold will fall further and support beckons at the rising long term mean (200 day moving average)at around 1750 in much the same way as it did in March bottoming at 1450. As an insurance policy against the unintended consequences of central bank action, which are legion, then gold has a very good long term track record in this respect. Devaluing the currency by profligate

printing being the number one sin. Julian Baring, one of the greats in precious metals fund manager circles, regrettably no longer with us, used to say that a gold sovereign would always be able to buy dinner for two at the Savoy for as long back as we have records and that is just as true today; with wine of course, Julian was a bon viveur par excellence too.

Silver and mining company shares are a geared play on the gold price and another option for those who can stand the high volatility. As an indication mining shares rose by over 1000% from 2000 to 2011 and then fell back to almost the starting point by the end of 2015. Since then, in volatile fashion, mining shares have trebled but are a long way from the 2011 peak when gold was about where it is today; so potentially still a lot of upside; potentially!

Index linked securities themselves will also provide protection against inflation, but never the full monte as it were as they are currently standing at levels deemed expensive, in part as a result of Fed buying. They are also by definition long duration assets so they will have equity like characteristics ie volatility, something that is hard to avoid these days.

Other investments with inflation linked income also have their attractions. Infrastructure funds have started to proliferate and with governments prepared to spend on new transport, hospitals and schools this trend will continue. The key is to find managers who can spot a profitable investment from the inevitable duds and be able to assess the ability of the project to fund the index linked payments. These will be property share funds and not the more traditional bricks and mortar offering that have significant liquidity issues, always at the wrong time although there is never a good time to be illiquid.

Equities can perform well in an inflationary environment especially for companies that have pricing power, but the main benefits historically have come after the inflation has been squeezed out of the economy by progressively higher interest rates. Once Volcker had done for inflation by pushing the 10 year Treasury yield to nearly 16% in 1981 it wasn’t long before the equity market took off on a 40 year bull market that still hasn’t ended. Right now the Fed is targeting higher inflation but has already said that it will not raise rates into an inflationary boom. That does sound pretty good for equities, but getting country, size and factor exposures right, not to mention valuations is going to be more important than just buying the index.

I can’t leave this topic without mentioning bitcoin so I will pause here for the ripples of laughter to subside… A digital currency? Hmm? Last week the ECB no less took out a copyright patent on the name “Digital Euro”, the Bank of England have been talking about digital money for a long time, the Swedes are pretty much there and so is China. But wouldn’t the central banks want the field completely to themselves? Maybe, but if they think that they can make the negative side of coin, in this case money printing, go away by digitising it then think again. The greater the supply of anything the lower its price and with a currency its purchasing power and store of wealth.

This is where bitcoin could shine. Its supply, or “flow “ in the jargon, is limited and increasingly so. The blockchain methodology which gives bitcoin its safe custody without relying on a single third party, like a bank, is provided by subjecting the transaction data to a rigorous checking process that requires significant computing power and multiple operators. Those able to provide such a service are rewarded with bitcoin dependent on the number of transactions they verify. The reward ratio is reduced at pre determined periods by 50%, again, in the jargon, known as a “halving”. So the stock of existing bitcoins to the potential flow is controlled in a downward direction unlike current central bank policy where the Fed’s balance sheet has grown to $7trillion and will likely get to $20 trillion once MMT (modern monetary theory) gets going after the election as seems highly likely.

It’s a complex subject and equally complex to implement but it is intriguing that none other than Fidelity have set up an initiative called Fidelity Digital Assets, initially for institutional players, but likely to become more widely available in time. A good book to read if there is interest is the Bitcoin Standard by Saifedean Ammous, available from your usual bookseller.

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