Deflation or Inflation?: In this ‘winter’ why financial history knows more about the ‘impossible things’ (06/04/20)

"If we winter this one out, we can summer anywhere."
- Seamus Heaney

Your author has spent too many years writing about deflation. This began with the expected deflation shock from the Asian economic crisis (Dealing With the “D” Word, The Solid Ground December 1997) and was also necessary in the recessions of 2000-2001 and 2008-2009. The probability of deflation has been the focus of various quarterlies over the past few years (see What the Hell is Water? Why January 2018 Marks a Generational Peak for US Equity Valuations, 4Q 2018 and When Debt Matters: Where to Expect Credit Crises in the Next Recession, 3Q 2019) based upon the analysis that QE was very successful at creating debt, but failed to create enough money.

Now we face another deflation shock. However, it is a deflation shock in which we should stop focusing on deflation.

The Solid Ground’s particular past interest in deflation springs from two sources. The first was the eighteen months of research for Anatomy of The Bear: Lessons from Wall Street’s Four Great Bottoms that revealed the destructive power of deflation upon equity valuations. Equity, that fine sliver of hope between assets and liabilities, does not fare well when prices and revenues decline faster than costs and the creditor is increasingly likely to be the owner of the corporations’ assets. This is why the likelihood of deflation has been the focus of The Solid Ground in recent years and why the 33.3X CAPE paid for US equities in January 2018 seemed to this author to represent a generational high.

Here we are again with another deflation shock and a rapid and dramatic collapse in cash flow, leaving equity owners asking whether a company’s assets belong to them, the creditors or perhaps even the government. Deflation has mattered because its arrival has not just raised questions about the level of dividends for equity investors, but has also raised the key question of whether equity investors have any claim to future corporate cash flows! In our current unique circumstances we don’t need deflation, as measured by government statisticians, to signal that there is such an existential risk to equity.

We are living through the most rapid and major decline in corporate cash flows ever recorded, and it comes by imposition of law and not the natural economic forces we have seen before. When that imposition of law ends tells us more about the return of corporate cash flows than any change in the recorded rate of inflation or deflation.

The second source of interest in deflation for your author was piqued by a comment from a leading academic who objected that The Practical History of Financial Markets Course (www.didaskoeducation.org), a course I founded at the Edinburgh Business School in 2004, was teaching students how financial asset prices performed in periods of deflation. Such teaching was unnecessary I was told because in a fiat currency regime it was ‘impossible’ that deflation could occur. The US is now very probably entering its third period of deflation since 2004.

These deflationary periods have not come as a particular surprise to most investors, even if they were long ago confined to the ‘impossible’ basket by academics. It has always been of great amusement to your author that so many things that are considered ‘impossible’ by economists feature so prominently in the pages of financial history. If, like the White Queen, you would like to believe ‘six impossible things before breakfast’, perhaps things a modern financial engineer might call ‘25-standard deviation moves, several days in a row’ before breakfast, then you need only read some financial history.

While the pace and scale of the current cash flow decline are exceptional, the economic and policy consequences are not. The corporate cash flow collapse came in just a few days and the deflation will
very probably follow, but what matters to investors now is the government response to this crisis. During this crisis period the recorded rate of deflation or inflation is thus of much less interest than before.

The key reason that investors need to stop focusing on deflation now is that reported inflation numbers, while the isolation of many companies from economic activity persists, are no longer lead indicators of anything. Historically that macro indicator we call ‘deflation’ was useful in telling us something about the direction of the cash flows that support all the liabilities we hold as assets in our portfolios.

At the bottom of the major bear markets investors thought that deflation could only worsen and thus corporate cash flows could only worsen, with very negative impacts for the price of their liabilities. Then somehow, often due to a major policy change whether monetary or fiscal, they began to realise that the scale of expected deflation was too gross. In Anatomy of The Bear: Lessons From Wall Street’s Four Great Bottoms I focus on the leading indicators that suggested the scale of deflation priced into financial assets was too great and that price stability and thereafter inflation could return. The focus was on inflation/deflation because these lead indicators of the general price level were also good indicators of the direction of corporate cash flows.

Those indicators worked in 2009 and they will likely work again for those companies impacted by this crucial change in macro trends that augurs improving corporate cash flows. However, in our current incredible economic condition it is not clear that the published data does carry such information, at least for those corporations isolated from economic activity. For those still trading, of course, trends in the general price level do impact revenues and cash flows. Even here, though, some caution needs to be exercised in interpreting what the official inflation/deflation data will tell us during this period of economic isolation.

There is a great deal of effort that goes into constructing the consumer price index basket. Despite that effort many quibble with its composition and particularly the hedonic adjustments that alter the price of key goods to account for the improvement in their quality/functionality. If such debate informs the accuracy of inflation statistics in normal times, how much more should we question the accuracy of inflation statistics in a lockdown? The carefully weighted components of the CPI basket now bear no resemblance to the actual purchases of a nation in lockdown.

Last week, using some of the funds provided by subscribers (10% of all revenues from The Solid Ground subscriptions go to charity), I tried to buy a chest freezer for the local foodbank. It was a long search to find one and when I found it it was trading at quite a premium to the regular price. It may have been the last chest freezer sold in the UK for the month of April, and if more are sold they might go for higher premiums still. There will be a collapse in the volume of transactions, indicating they now form a limited part of the average purchasing basket, but there will be a spike in the price of chest freezers and the weighting in the official basket will be largely unchanged.

What will be the ‘correct’ price of automobiles in an economy where virtually none are sold? Will the statisticians leave such prices unaltered from their March levels? In this extreme time we are measuring the prices of the wrong goods, and the prices of the goods we are measuring are grossly distorted by the closure of much economic activity. The inflation rate now suffered by the average consumer can bear little relation to the inflation rate as calculated by national statisticians. For the duration of this crisis the inflation rate alone can tell us little about the decline, or rise, in the real purchasing power of savings. However, this will not stop much ink being spilled over the next several months on the inflation data by many economists, strategists and investors.

Whatever the inflation data reported over the next several months, they are unlikely to tell us anything that is of material importance for the level of asset prices. In time, of course, it will be absolutely crucial data in the battle to preserve the purchasing power of savings and, indeed, will become the most important data. For now the published CPI data can lead investors down dark and dangerous investment cul-de-sacs, if they use it as a guide to seek to preserve and enhance the purchasing power of savings.
For those who expect the change from deflation to inflation to signal a buy for a company legally restricted from seeking revenue, then there is necessarily a nasty surprise coming. The move from deflation to inflation has been important as a lead indicator for corporate cash flows but it can play no such role for companies who simply cannot benefit from the stabilization, and then rise, in their selling prices. Thus investors today have to look, for some companies but not all, at when their cash flows are likely to begin to return and the answer to that question lies with epidemiologists and politicians and not with the direction of the general price level. So, for some companies a rise in selling prices can feed quickly through to higher revenues and through operational gearing to higher profits. Some companies could still be watching this ‘normal’ turn in the economic tide from the sidelines.

A further problem in calling the bottom for each company’s share price based upon stability in the general price level will be the scale, and the terms and conditions of any government bail in/bail out. The Solid Ground has picked up the production schedule and subscribers will have recently received The Long And Winding Re-equitisation: Japanification With Inflation (for subscribers a follow-up on the calamitous implications for EM capital controls on developed-world banks will follow soon after this report) that focuses on which countries are more likely to bail in the existing capital structure than bail it out.

The scale of capital flooding into the entire commercial system, well beyond the usual bank recapitalisations that have marked some bear market bottoms, will condition soon where corporate cash flow will flow for the next several years. It is possible, under certain terms and conditions, that current equity investors might not be entitled to any of that cash flow in the form of dividends or stock buy-backs. This is a new feature for the non-financial corporate sector of this particular bear market.

Of course, the time will come again when what counts is whether deflation persists or we enter a new period of higher inflation. Subscribers will know that The Solid Ground has long expected that deflation to trigger a move to ‘financial repression’ that has to be a world replete with inflation. That financial repression is engineered by a dramatic structural shift, imposed by legislation, in how the savings system works. Its aim is to drive inflation permanently above the risk-free yield curve by forcing savers to buy fixed-interest securities that promise appalling real returns.

Your analyst, who long argued why QE would create deflation, now finds himself having to argue that it is possible to create the inflation that is the key element of any successful financial repression. Many investors now believe that the authorities simply now cannot create inflation. A full discussion of how inflation can be created, against a background of the structural deflation that has been evident for many years, must probably wait for the publication of the next quarterly report. At this stage we can still focus, albeit briefly, on how the nature of current central bank/government policy can set the scene, or not, for very high inflation as soon as the lockdown ends and the recovery comes.

Subscribers will already know where so-called ‘helicopter money’ is most likely to be distributed - Helicopter Money: Where it Comes and Where it Goes, 1Q 2020 The Solid Ground. In discussing why helicopter money is coming, that report focuses on why QE failed as it failed to stimulate high growth in bank credit growth and thus high growth in broad money. What is really important in this crisis is that it may be the first, at least since the 1970s, in which bank balance sheets significantly expand!

Such an expansion is already evident as corporations, much as they did in late 2008, rushed to pull down credit lines with banks and boost their precautionary cash balances. While bank balances sheets then began to contract from their peak level in 4Q 2008, there is a growing prospect that this time they might continue to grow. In the US bank credit has grown by 5.5% in a month as those credit lines have been drawn down, but now one would expect banks to cut back on lending to troubled borrowers and companies with strong cash flows to perhaps seek to pay down debt. Through such mechanisms bank credit usually contracts during a recession, but there is something different happening this time. This time the governments might be forcing bank balance sheets to expand through a recession!
Given, hopefully, the very temporary nature of this public health and economic crisis, many governments have decided to utilize the commercial banking system as a key conduit of policy to get cash to where it needs to be to forestall mass bankruptcy. In extremis this policy could simply mandate that banks expand their balance sheets to support companies and individuals that now find themselves with insufficient cash to cover their expenses.

It may be that the state provides guarantees for such loans, but the monetary impact would be the same. Bank credit would expand and money would be created, potentially at a very high rate. This act of money creation would be unlikely to have any inflationary impact at first instance as the lockdown of the economy means that velocity has collapsed. However, as the lockdown ends and the recovery begins, there would be a much greater stock of money in the system which would very likely have inflationary impacts when velocity returns to near normal levels.

While we can all speculate as to how long it might take for velocity to normalize, we can all also measure the scale of the potential inflationary powder keg - in the form of a much larger supply of money, that can be ignited when it does. At this stage we can do little more then observe the growth in bank balance sheets and the scale of money creation. The more governments rely upon their effective capture of the commercial banking system to directly fund businesses and households through this crisis, the more they risk an inflationary blow-off when the economic lockdown ends. The more they use their own balance sheets, gathering existing money through the issuance of government debt to sustain the private sector through the lockdown, then the less inflationary the consequences.

Not all governments will proceed in the same fashion and the differing approaches will, in time, result in very different paths for inflation and crucially for exchange rates. Monitoring just how each country proceeds along this path will be the key subject for the next quarterly report for subscribers, and no doubt they will have to be monitored very closely for some quarters to come. The Solid Ground remains convinced that policy makers will attempt a grand financial repression and also that, through the creation of too much money, they will be able to generate the high inflation which is key to a successful financial repression. However, this is not the same thing as saying that they engineer the inflation or the associated curbs on the free allocation of capital smoothly. The erratic path to the level of inflation necessary for a successful repression, probably 6% or even higher, will be a difficult one for investors to navigate.

Having spent more than twenty years writing about deflation, your analyst will stop sometime in this economic contraction. He will stop because any deflation reported in this economic contraction will actually tell us much less about corporate cash flows than it has done historically. He will also stop writing about deflation because we are entering a financial repression when governments will have to keep inflation above interest rates for at least two decades to reduce debt-to-GDP ratios to less lethal levels.

In such a system deflation will likely be a term confined to the dustbin of history, much as it was for the post WWII period until 2008. The journey from here to that repression will no doubt be full of twists and turns, threats and opportunities for investors. Many of those twists and turns will be enforced by government diktat to subvert the market in order to create the financial repression. The Solid Ground, utilising examples from financial history combined with the analysis of credit and money, is here to help with those twists and turns - and those six apparently ‘impossible’ things, at least impossible to economists and algorithms, that a government, desperate for a financial repression, can bring us before breakfast.
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