The Dawning of the Age of Inflation (12/06/20)

The age of disinflation and deflation is over. In the 2Q 2020 report to be distributed to subscribers next week The Solid Ground looks at why the money creation process has already passed from central banks to governments and an age of inflation is now upon us. This is a huge structural change in the nature of money creation and it creates a form of money which has many more direct impacts on nominal GDP than the central bank money creation we know as QE. The report forecasts that inflation across the developed world will exceed 4% by 2021 and will very probably move higher as central banks are impotent to stop the newly launched government money-creating machine.

In the new quarterly - The Birth Of The Age of Inflation: Why It Is Now And What To Own - your analyst looks at how this new form of monetary growth changes financial markets for a generation and also lists the under-owned asset classes to own now. The report looks at the lessons investors learned in the last age of inflation, from 1966 to 1982, and how all those lessons have been forgotten by a generation of investors who have only operated in an era of disinflation. For the first time in twenty-five years of writing research for professional investors, your analyst finds himself as an inflationist.

Markets, of course, discount and we have seen a huge rally in equities, particularly US equities. Has the rally in the equity markets already signaled this new age of inflation? Almost certainly not. Such a high degree of certainty in any opinion on cause and effect in financial markets is dangerous, but in this case it is an opinion based on key price signals coming from another market - the indexed-linked bond (ILB) market. The table below shows the current breakeven inflation rate for key ILB markets and also the 2020 low breakeven inflation rates.

<table>
<thead>
<tr>
<th></th>
<th>Current</th>
<th>2020 lows</th>
</tr>
</thead>
<tbody>
<tr>
<td>US</td>
<td>0.98%</td>
<td>0.18%</td>
</tr>
<tr>
<td>UK</td>
<td>2.61%</td>
<td>2.38%</td>
</tr>
<tr>
<td>France</td>
<td>0.19%</td>
<td>-0.25%</td>
</tr>
<tr>
<td>Germany</td>
<td>0.39%</td>
<td>0.03%</td>
</tr>
<tr>
<td>Japan</td>
<td>-0.11%</td>
<td>-0.40%</td>
</tr>
<tr>
<td>Italy*</td>
<td>0.17%</td>
<td>-0.40%</td>
</tr>
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*four year ILB breakevens as five year unavailable

As the table above shows, inflation expectations had risen somewhat from their lows at the worst of the market risk sell-off in March this year. However, in Europe and Japan in particular, the rate of inflation priced into ILBs remains remarkably low. Whether it is France, Italy or Germany the ILB markets are pricing in a level of expected inflation, over the next four or five years, that these countries have never before reported post-WWII. Clearly markets are not pricing in any dissolution of the euro, given current yields on member-state bonds, so these incredibly low European indicated breakevens are forecasting at least five more years of virtually no inflation and the continuation of the single currency with the ECB constantly missing its inflation target - by a mile!

If we look at ten year ILB breakevens, we see the same thing. How many people believe the EU or the euro, with some of the world’s most indebted nations, could survive in their current form in five years or a decade where inflation is virtually non-existent? It is not consistent to believe that the euro survives and also that there is no inflation within the Eurozone. That the market holds such inconsistent views creates opportunities for investors. It is time to bet on higher inflation in the Eurozone and the new quarterly report explains just how that inflation is being created. It is also time to bet that it is highly likely that inflation so created will trigger the end of the single currency. Eurozone ILBs now offer investors good value given the passing of the money creation role from central banks to governments.

The Solid Ground has long pointed out the deflationary dynamics of QE, a policy that excelled in creating non-bank debt but failed to create more than moderate growth in broad money. After more than a
decade toiling in the money mines, central bankers had failed to create more money and OECD broad money growth was at the lowest level ever recorded, apart from the period of the GFC. Now suddenly success as across the developed world, in the midst of a deep recession, broad money growth is soaring! As the 2Q report describes, there is now a new way of creating money and many developed-world countries are already seeing the highest level of broad money growth since 2007 - some having already exceeded that level.

It is highly likely, given current trends and government policy, that global broad money growth will be at levels not recorded since the 1980s - perhaps even before the end of this year! You don’t have to be a fully signed-up, card-carrying, Friedmanite to believe that such rapid growth in broad money, likely in excess of 10% across the developed world and even perhaps in Japan, may not be consistent with the record low rates of inflation now priced into the ILB markets. Regular readers will know that The Solid Ground has long forecast that our next recession would bring a rapid acceleration in financial repression and the key ingredient of such repression would be much higher inflation. Well, here we are, and the financial assets that provide protection from such inflation continue to languish even as it is clear that governments have seized control of money creation from the central bankers. For the past several years The Solid Ground has recommended investors own gold, and the case for the yellow metal is getting stronger by the day now that politicians control the supply of money.

While ILBs are, of course, subject to manipulation through changes in the inflation calculation, they still represent one of the few assets that can assist investors in maintaining the purchasing power of their savings in an age of inflation. After around forty years of disinflation, financial market capitalization is dominated by disinflationary winners. In particular these winners dominate the equity markets. For a generation disinflation has held down the variable costs of many businesses, while the lack of price rises has punished the profitability of those asset-heavy companies with high fixed costs. The ever lower levels of nominal GDP growth have resulted in the steady decline in the risk free rate that has rewarded, with ever greater valuations, the higher growth achieved by asset-light companies. Asset-light companies have been disinflationary winners and asset-heavy companies the disinflationary losers. The new quarterly report looks at sector performance from 1966 to 1982 for US stocks to evaluate where investors might preserve wealth through stock selection in our new age of inflation.

While this is not exactly the growth value debate, as not all value stocks have high operational gearing and some face structural redundancy, it is related to that debate. In a world of much higher inflation, investors should expect higher nominal interest rates, though they will fall in real terms, but also a return to higher revenue growth and higher profit growth for operationally geared companies. The gap between the return on corporate capital and interest rates can fall for growth companies but rise for asset-heavy companies. Crucially this dynamic comes at a time of record valuation divergence for the two sectors.

The premium valuations for growth over such value assets create an opportunity for a significant out-performance for asset-heavy companies relative to growth stocks. For those companies with high variable costs, higher inflation means higher input costs - particularly labour costs - and their first real struggle in a generation to defend operating margins. If price is what you pay and value is what you get, then markets currently price in that the advantage brought to asset-light over asset-heavy companies will now last forever. That seems highly unlikely to be correct, if we are now entering an age of inflation.

China played a crucial role in the age of disinflation. Its state-controlled banking system funded investment over consumption and as a result the very high growth of China actually put downward pressure on global inflation. The country devalued in 1994 and from then it operated with a grossly undervalued exchange rate as it mobilised its vastly under-utilized resources - particularly in labour. This played a huge role in depressing global inflation, but those days are over.

The Solid Ground has long argued that the developed world is entering a Cold War with China and trade flows between nations involved in a Cold War stop! Even if some form of trading relationship can continue, China has long inflated away the cost advantages which saw it depress the price of globally traded goods by adding cheap and abundant labour to cheap and abundant capital. Either China’s ostracization creates higher inflation as a key source of capacity is embargoed, or a move to a reflation
in China pushes global inflation higher. A devaluation of the RMB, while initially deflationary, simply accelerates the ostracization of China from the global trading regime and forces the country to grow more through boosting demand than investing in supply. For those asset-heavy companies that have struggled to compete with China relief is on its way.

The last quarter of a century is neatly book-ended, at least in investment terms, by a devaluation of the RMB at one end and the ostracization of China from the global trading regime at the other. That period produced lower inflation and lower interest rates but particularly higher corporate profit growth for the asset-light companies that now dominate US market capitalization. It was a period when the US corporation changed to offshore manufacturing and created a new capital-light business of creating and selling brands. It was a period when ever lower interest rates and higher cash flows allowed the financial engineering that shrunk the equity base of most companies and pushed share prices higher. This era has ended due to a shift in money creation to governments, but also because China’s role in depressing global inflation has ended.

An age of inflation and, in particular, an age when China no longer depresses returns for many asset-heavy companies puts these key positive trends for asset-light companies into reverse. In the age of disinflation, which accelerated with the devaluation of the RMB in 1994, US equities have been in a prolonged rise, increasingly dominated in terms of performance and market cap by asset-light companies. Over the same period Japanese equities, asset-heavy and driven to degear rather than add leverage, have been in a prolonged bear market. There will always be good fundamental reasons to justify such prolonged divergences in returns between the two countries’ equity markets, such as greater entrepreneurialism or more focus on producing returns to shareholders. While these key differences have indeed been important, one must not ignore that the US business model has benefited from disinflation and most Japanese companies have suffered from the same force.

For a long period liquidity generation did not act to push inflation higher, thus creating the opportunity for interest rates to fall and the price of growth assets, in an age of low nominal GDP growth, to be bid up. Today asset light/growth equities are being bid up again and some to new highs. This reflects the winning belief, over many decades, that when excess liquidity is created it cannot push inflation and interest rates higher, but it can push equity valuations higher - particularly of growth companies where earnings’ growth remains robust when GDP growth remains lacklustre. That era has ended.

It has ended because the money now being created is not central bank money but money created under the direct control of governments. Governments so enfranchised to create the higher nominal GDP growth they have so longed for will not surrender such a potent policy tool when a crisis ends. Those who believe that governments retreat from such emergency measures are presumably still waiting for the repeal of income tax introduced in 1798 by Pitt the Younger to finance the defeat of Napoleon!

For subscribers still pondering the difference between the two forms of money and their very different impacts on growth, inflation and asset prices, *The Birth of The Age of Inflation: Why It Is Now And What To Own* will hit your desks, well in-boxes, soon. While the world remains distracted by central bank pyrotechnics, a monetary revolution has already occurred and the financial repression, red in tooth and claw, is already tearing at savings. There are few places to hide, and the secret of maintaining the purchasing power of savings is not to own particularly esoteric or obscure asset classes. The secret is to own those asset classes most likely to protect real wealth in sufficient size, even if this leads a portfolio to be dramatically different from index weightings. That is not a matter of intelligence. It’s a matter of bravery.
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