Evenlode Investment View

Wise Funds

NOVEMBER 2011 – INFLATION: THE PATH OF LEAST RESISTANCE

Reasons To Be Cheerful – Or Not

Stock markets don't know quite what to do with themselves at the moment. On the one hand, companies are generally trading well, and making a good fist of adjusting to the 'new normal' of long-term economic deleveraging - predictably miserable is better than shockingly bad. Meanwhile, after falling off a cliff over the summer months, global leading indicators have begun to stabilise. Although headlines are dominated by Europe's dire situation, falling inflationary pressures over recent months should, at the margin, start to help the embattled global consumer. The fact that we most likely face a period of several years of slow economic growth doesn't mean there won't be conventional business cycles in the meanwhile – they're just likely to be shorter and less impressive. In this context maybe - just maybe – the seeds of an economic recovery in 2012 have been sown over the last few months.

So, some reasons to be cheerful in the brief interludes between European rescue summits. However, these summits (and more specifically the inability of European policymakers to get ahead of events) act as a counterpoint to this optimism. The Eurozone casts a long shadow over the global economy, and it remains clear that there's a lot to be done before the European situation is stabilised. The latest October package failed to answer the most important question regarding Europe – who's inside the firewall and who's out? Greece, finally, has been implicitly placed outside this firewall, now that policymakers have admitted its debt must be restructured. Subsidiary questions include; who else needs to restructure (Portugal, Spain, Ireland, Italy?), who are the countries whose sovereign bond markets will be defended at all costs, and when will the European Central Bank step in as buyer of last resort? All, so far, unanswered.

Inflation – The Path of Least Resistance

The Eurozone crisis is a symptom of a wider problem - unsustainably high government debt levels. History suggests that, over time, these debt levels will gradually come back down again to healthier levels. Some of this reduction will occur thanks to debt restructuring and austerity packages and, at the margin, some will occur thanks to economic growth. But history also suggests that the lion's share of this reduction will be achieved by persistent long-term inflation.

Academic Carmen Reinhart released an interesting paper this year called 'The Liquidation of Government Debt'. In it she coined the term 'Financial Repression' to describe a period (such as 1945-1980) of persistently high inflation and low interest rates during which a government's debt steadily reduces in real terms. This process seems to be the most socially palatable way to reduce debts over the long-term, and far more palatable than austerity. A society might put up with austerity measures and deflation for a year or two, but over much longer periods, austerity doesn't wash. As Reinhart puts it:

"The ongoing discussion of how public debts have been reduced in the past has focused on the role played by fiscal adjustment. It thus appears that it has been collectively "forgotten" that the widespread system of financial repression that prevailed for several decades (1945-1980s) worldwide played an instrumental role in reducing or "liquidating" the massive stocks of debt accumulated during World War II in many of the advanced countries."

Interestingly, the level of government debt to GDP in developed nations was almost identical in 1945 as it is today (c80%). Some commentators worry that the ultimate denouement of today's debt levels will be hyperinflation. While possible, Rheinhart points out that the job could again be done by more moderate levels of inflation:

"during the period between 1945-1980, the annual liquidation of debt via negative real interest rates amounted to 3 to 4 percent of GDP on average per year. Such annual deficit reduction quickly accumulates (even without compounding) to a 30 to 40 percent GDP debt reduction in the course of the decade."

Given this mechanism for debt reduction, I'd expect easy monetary policy and bouts of quantitative easing to continue for some time in developed nations. The 'longing' for an end to deflationary pressures is so great – both for policy makers and the general public – that it's likely these measures will continue to win out in public debate. This bias was summed up succinctly by Ben Bernanke in his now famous 2001 speech '*Deflation: making sure 'it' doesn't happen here*':

"U.S. dollars have value only to the extent that they are strictly limited in supply. But the U.S. government has a technology, called a printing press (or, today, its electronic equivalent), that allows it to produce as many U.S. dollars as it wishes at essentially no cost. By increasing the number of U.S. dollars in circulation, or even by credibly threatening to do so, the U.S. government can also reduce the value of a dollar in terms of goods and services, which is equivalent to raising the prices in dollars of those goods and services."

I wouldn't be at all surprised if the European Central Bank join the US, the UK, Japan (et al) and begin to print money too. The Germans don't like the idea – they still have a residual memory of the 1920s hyperinflation in their psyche, but ultimately I suspect financial markets will force Germany and the ECB to radical action.

Inflation Protection

Persistent inflation might be the most palatable way for society to reduce its debts, but it presents a big problem for savers and investors, requiring us all to pedal furiously to stand still. Inflation in the modern world of paper money has been relentless since the Pound decimalised in 1971. £1's purchasing power has declined by more than 90% in the intervening 40 years. In today's world, inflation may prove an even stronger force.

So what do we do? As I've discussed before (e.g. *An Eye On Inflation – November 2009*), our preferred method of achieving inflation-protection is to buy asset-light businesses with strong customer loyalty (perhaps I labour the point, but I think it's crucial). This type of business tends to achieve price rises that at least keep up with inflation over time, and because their investment requirements are minimal, the extra cash-flow produced can be mostly retained for shareholders. Our largest holding, Unilever, is a case in point. People will continue (even in Europe!) to buy Unilever's products over coming years – they will wash their hair, eat ice cream and drink tea. And Unilever's investment requirements remain very small relatively to profitability. As a result, cash-flow continues to come back to shareholders by way of a steadily growing 4% dividend yield.

The Value In Quality

Given their all-weather qualities, you might expect Unilever-like businesses to be priced rather highly, but I continue to be impressed by their valuations. We value stocks as if they were infinite-maturity bonds, and our valuation methodology ('forward cash returns') is the stock market equivalent to a bond's redemption yield. Currently, the Evenlode portfolio's 'redemption yield' is more than 10% (and on our estimates several stocks, including Unilever, sport significantly higher forward cash returns than 10%). In contrast, the UK 10 year gilt offers up a redemption yield of just north of 2%. The other nice thing about owning businesses in the uncertain backdrop of today, is they can adapt to changing economic environments; listening to their customers, evolving their product offerings, and generally doing their upmost to stay afloat on the changing tide – inflationary or not. A bond can do none of these things.

Warren Buffett, as he often does, summed it up nicely this week (in a TV interview following news that he is back buying shares again in a big way):

"I can't think of a lot of attractive bonds and I certainly can't think of a lot of attractive currencies to stick in my pocket. But there are a lot of attractive stocks out there."

Here, here, I say. In the last few months high quality multinational shares have begun to outperform, but their forward cash returns remain very compelling. As a result, we are sticking to our guns.

Hugh Yarrow
November 2011

Please note, these views represent the personal opinions of Hugh Yarrow as at 15 November 2011 and do not constitute investment advice.