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A Tale of Two Inflations

"It was the best of times, it was the worst of times,
it was the age of wisdom, it was the age of foolishness…"

'A Tale of Two Cities', Charles Dickens

"Deflation is what you own and inflation is what you need".

US Fund Manager

Are we faced with inflation or deflation? This is the single most important judgement to make when formulating an investment plan. The table below summarises the current position and consensus forecasts for a number of leading economies. Apparently, all is in order.

	CPI %	Mean Forecast 2010 %
UK	1.1	1.98
US	-1.3	1.88
Japan	-2.2	-0.53
China	-0.8	2.74
Eurozone	-0.3	1.23

Source: Bloomberg

CPI: An inflationary indicator that measures the change in the cost of a fixed basket of products and services, including housing, electricity, food, and transportation. The mean forecast is from a survey by Bloomberg.

Looking beneath this calm facade tells a different story. It is particularly striking that policy makers are focussed on dealing with deflation whilst investors seem to be more worried about inflation.

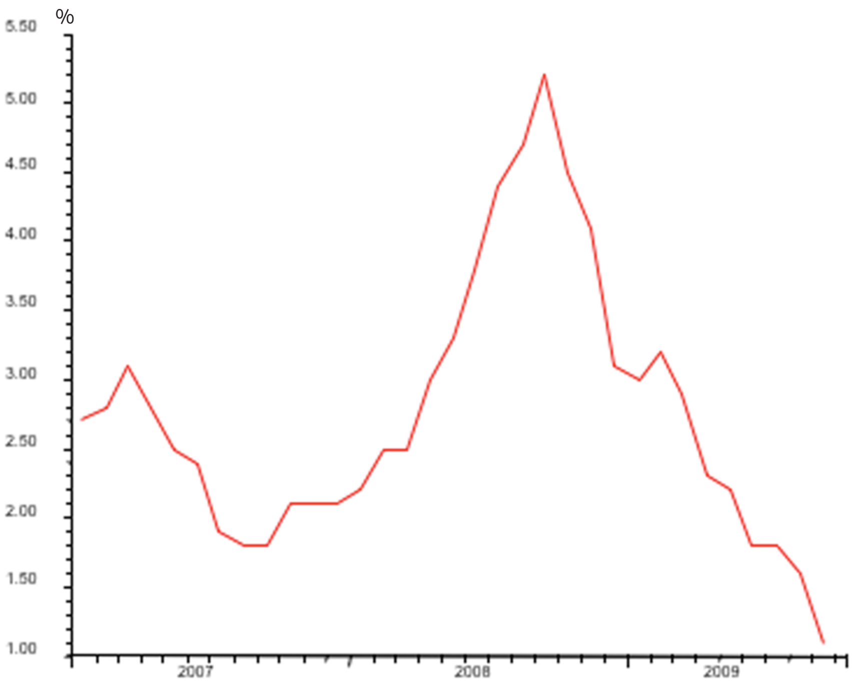
I previously wrote about inflation in April 2008 to coincide with the removal of indexation from the calculation of UK capital gains tax; a 'benefit' that had been provided with great generosity by successive governments during twenty six years of falling inflation:

http://www.cheviot.co.uk/news/2008/04/inflation-matters

I concluded that an inflationary spiral was unlikely, but even low inflation was corrosive and that tax paying investors needed to achieve a return of 10% gross per annum just to keep up with the average inflation rate over the last twenty five years of 3.7%. Low risk investments and guaranteed return products would not be good enough. To put these views in context, economies and markets were already suffering from the credit crunch, but this was before the Lehman's collapse and the massive intervention by governments and central banks that we are now living with. Nevertheless, these conclusions remain valid.

Those who subscribe to a disinflationary, or more controversially, a deflationary outcome cite the benefits of globalisation, low capacity utilisation and the likely effect of government spending cuts over the next few years. Inflation supporters focus on the actions of governments and central banks to stimulate economic activity through increased spending right now and the increase in the money supply through quantitative easing.

UK CPI Inflation 2007-2009



Source: Thomson Datastream

What is beyond doubt is that a massive amount of money has been pumped into the system in what is an unprecedented monetary and fiscal experiment. As an indicator of economic activity, commodity prices have responded.

Commodity prices 2007-2009

Source: Bloomberg

The debate by strategists and economists will continue until one side or the other is able to proclaim victory. Perhaps the inflation/deflation debate is just a timing effect. Even those predicting high inflation acknowledge that this will be a multi stage, multi year process. Initially an increase in money supply will benefit asset prices including stocks and shares, which is where we are now. An improvement in economic activity will follow over the next two years followed by higher consumer price inflation in 2012.

It is just too early to say with any certainty, but what is happening at a company level does provide some guidance. In the retail sector, for example, fresh food prices are down 1.7% year on year from a peak of +16.8% in February. In contrast basic foods such as rice and pasta are, on average, 4.5% more expensive than a year ago. Non food retailers have lived with price deflation for ten years and there are no signs of this changing. DIY stores on the other hand have been able to sustain price increases although even here higher prices at the hard end (timber) are more sustainable than the soft end (home furnishing). I am grateful to Tosca Metriks for these statistics. Overall, consumers are trading down to cheaper products and are reducing discretionary spending on non essentials. The headline inflation rate is a combination of factors that are cancelling each other out.

When an inconvenient fact challenges a well constructed theory investors should go with the former. To summarise;

- Inflationary pressures are likely to remain low although in the UK we will need to monitor currencies particularly closely.
- Asset prices are benefiting from the extra liquidity provided by governments.
- Some companies are coping better than others and so good stock selection will drive investment performance.

A 'Tale of Two Inflations' is, of course, a gross simplification, but for the moment, investors are benefiting from 'high inflation' of the assets that they own and 'low inflation' of what they consume. An unstable equilibrium no doubt, but one that seems sustainable for the moment.

David Miller

28th October 2009