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The Coming Inflation

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In 2010, just after the global financial crisis of 2008, a long list of esteemed economists and commentators were signatories to an open letter sent to then-chairman of the Federal Reserve, Ben Bernanke. The main point of the letter was to serve as a warning that the large-scale asset repurchase program, which later became known as quantitative easing, would risk uncontrolled inflation. Their pleas went ignored by Bernanke. More surprisingly, uncontrolled inflation did not rear its ugly head during the subsequent 10 years.

Were the signatories of the letter simply early with the forecast or was the forecast misguided? They would most likely argue that the former was the case. However, there is not a world of difference between being early by 10 years and being wrong.

Why did the economists wrongly forecast the magnitude of inflation? It certainly was not because of a lack of intelligence or effort. Rather, it is because they attempted to forecast something that is incredibly difficult to forecast.

Ignoring monetary policy, trade wars and actual wars, inflation is also dependent on consumer behaviour and technological progress. And each of these variables can interact with the other in often unpredictable ways. The strong deflationary force created by technology is not often discussed but could be a reason why inflation remains stubbornly low, in spite of the action carried out by major central banks.

However, what if inflation does come back with a vengeance, after the copious servings of liquidity being pumped into the market by major central banks? By vengeance, we mean inflation in the high single digit to the low double-digit range, similar to what happened in the 70s in some western economies. Which assets protect or destroy wealth in such a scenario?

Cash and most fixed income holdings do not provide protection during periods of high inflation. Alternative assets like gold and timberland have historically been good hedges against inflation. However, what about equities?

What causes share prices to go up and down? Reality and perceptions of reality. The latter is the multiple people pay on a stream of earnings. When people are optimistic, multiples like the price to earnings ratio go up. When they are not too optimistic, the reverse happens. We will abstain from speculating about perceptions of reality and focus on what is knowable – the reality of a company's economics.

Companies with high working capital requirements and large fixed assets will struggle during bouts of inflation. Cash will be extracted from the company's coffers to spend on acquiring new inventory or on capital expenditures at now inflated prices. These companies need to run fast to simply stand still. Naturally, companies with minimal working capital requirements and fixed assets will thrive.

This of course does not mean traditional manufacturing business are all bad. After the Second World War, the cement industry thrived because inflation had significantly increased the cost of a new plant, deterring competitors from setting-up shop. This reduced the supply of cement and drove prices up, allowing the incumbents to generate significant profits for their shareholders and protect wealth while inflation ravaged the savings of most people.

Most investors look for signs of increasing demand to gauge the prospects of a sector. This is however only one part of the equation. As COVID-19 continues to ravage cyclical industries, lower profits will lead to the collapse of some incumbents. For the survivors, lower profits will mean lower capital expenditures, industry consolidation and lower future supply. Throw in high levels of inflation and you sow the seeds for the subsequent recovery as potential competitors are deterred by lower returns on capital since they will now need to invest in fixed assets at inflated prices to simply replicate the asset base of the surviving incumbents.

While we do not know the magnitude of the coming inflation, we remain fully focused on preserving and growing the savings of our clients by holding some inflation protection like gold, inflation hedged bonds and equities with limited capital requirements, as well as some exposure to cyclicals that will thrive as companies that survive benefit from less competition and lower future supply.