GLOBAL FOCUS CAPITAL LLC
INSIGHT THAT MATTERS

Feeling A Bit Deflated This Year?

With the rough start to 2016 most investors are feeling a bit deflated. Not only are most asset classes in the red but now there is even talk about the dreaded D word – **Deflation**.

The D word does not easily roll off our tongue but in a world of slack capacity, a commodity market meltdown and monetary authorities willing to experiment with negative policy rates maybe we should start practicing saying the word.

I used to think that only socially mal-adjusted strategists believed that deflation was a possibility in the US. After all we live in a world where fee increases are a fact of daily life. Just look at health care or college tuition payments. Or, if you live in Boston as I do just check the annual increases in the cost of public transportation. What we talk less about, of course, are the items for which we are seeing <u>price decreases</u>.

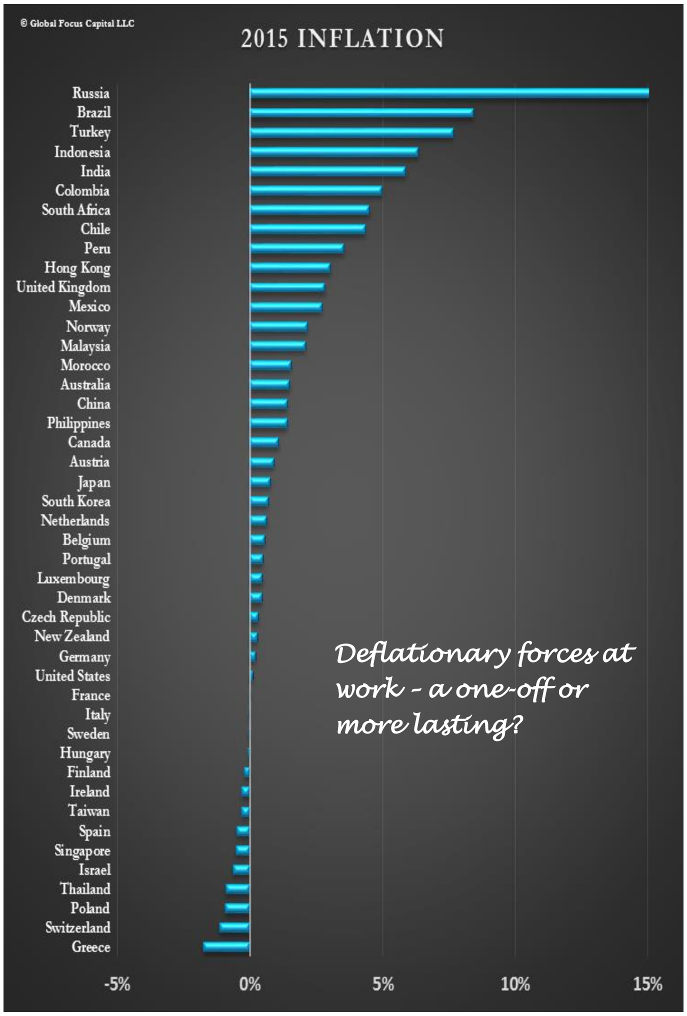
For example, items tied to energy and other commodity consumption have been getting cheaper and cheaper. Energy related consumption which accounts for 7% of the CPI-U calculation in the US experienced a 12.6% drop in price last year. Apparel was another category experiencing price drops.

Every country consumption basket is different, but nonetheless most developed economies have been experiencing very low levels of inflation anguishing monetary authorities deeply concerned about the negative effects of a deflationary spiral. <u>A deflationary spiral is one where aggregate demand growth is continuously insufficient to mop up the available supply of economic resources and prices need to commensurably come down.</u>

Most developed country central banks are targeting a 2% rate of inflation but are nowhere near that goal.

However, in recent years despite all attempts to revive aggregate demand (by lowering policy interest rates and even buying up long-dated bonds) several of the major central banks have fallen shy of this goal. The specter of a deflationary spiral looms large in the minds of central bankers.

There is nothing magical about a 2% rate of inflation but many economists believe that such a level is optimal for promoting the dual mandates of full-employment growth with price stability.



The list of central banks now using negative interest rates to prop up growth includes the ECB, the Swiss National Bank, The Swedish Riksbank, the Danish National Bank and as of two weeks ago, the Bank of Japan.

Even the Bank of England and the US Federal Reserve are contemplating enhancing their policy tools to include negative short-term rates.

The basic idea behind the use of negative rates is to penalize cash hoarding and instead encourage productive investment and spending.

Currency policy is also often part of the rationale for using negative interest rates as central banks seek to depreciate their currencies to prop up export growth.

Suffice it to say that the potential for "unintended" consequences when central banks resort to the use of negative interest rates is large and unpredictable.

How close to reality is deflation?

A deflationary world scares policy makers to death. The recent example of Japan's struggles to find their way out of a deflationary spiral are well documented.

Let's take a look at last year's inflation numbers from across the globe. We use standardized inflation numbers so the figures may slightly differ from those reported by government agencies.

- We observe that the base or average rate of inflation across all countries is pretty low – 1.4% if one removes the outliers in the tails.
- Countries with higher inflation rates are located in emerging economies such as Russia, Brazil, Turkey, Indonesia and India.
- The specter of deflation is already present in countries such as Greece and Switzerland and is not far off in a large number of other economies particularly those in Continental Europe.
- Inflation rates in developed economies are closer to zero than to the 2% target number of central banks
- Over the last ten years the average annualized rate of inflation for the countries in the above chart has been 2.7%
- No country in our sample has experienced a negative annualized inflation rate but Switzerland (0.25%) and Japan (0.31%) have come close

Are deflationary forces likely to persist?

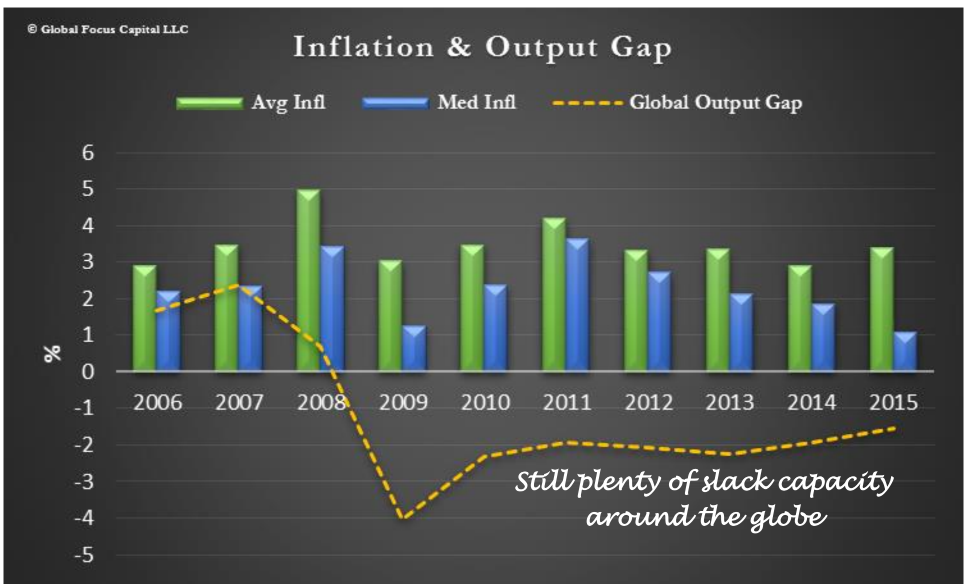
As mentioned before deflationary forces are a byproduct of aggregate demand not keeping pace with the productive resources and productivity of an economy. Negative inflation rates have been relatively rare in the last few decades but the great fear is that once people expect lower prices in the future they will curtail their consumption and investment activities. The fear is especially accentuated should deflationary forces persist over multi-year horizons. That's why at the first whiff of deflation monetary authorities tend to be ready to act and stimulate economic growth.

But what if the forces creating this negative inflationary environment are not temporary in nature? What if there is something structural at work that even negative policy interest rates can't alleviate?

One way to examine this question is to look at the full-capacity level of economic activity of a country and assess the deviation from current levels. Economists use the concept of the **Output-Gap** to measure the difference between the current performance of the economy and that possible.

A positive Output-Gap means that the economy is delivering above expectations. Such a situation occurs when, for example, resources are used for longer periods of time than is usual. Another way for a positive output gap to occur is when there is an unexpected boost in productivity. If an economy exhibits a positive Output Gap for a sustained period of time price inflation usually starts creeping in.

In the case of a negative Output-Gap the reverse holds true. Productive resources are not being fully utilized and the economy is under-performing. Outward signs of this include low levels of GDP growth, low levels of capacity utilization and unemployment rates above those deemed normal.



A persistently negative gap between actual and potential production could eventually be accompanied by falling prices.

The period 1998 to 2015 for Japan is illustrative. The output gap was negative every single year averaging -2.45%. Annual deflation came in at -0.36% per year while GDP grew at a below trend annualized rate of 0.85%. Short-term interest rates averaged 0.16% over this seven year period.

A similar situation is afflicting major global economies in 2016. The global GDP output-gap has been negative since 2009, policy interest rates are either close to zero or negative and GDP growth has been below historical norms.

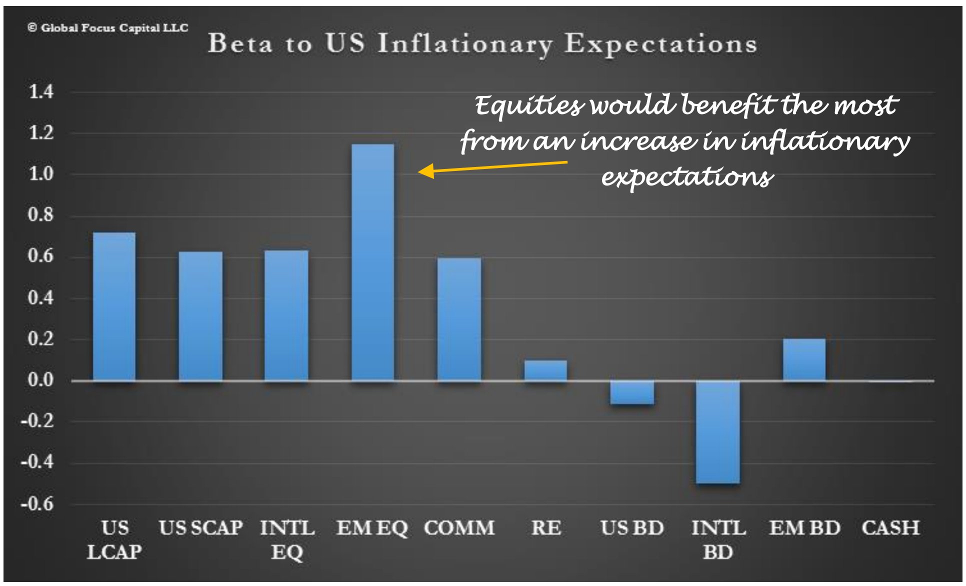
While global growth has been positive post 2008 Financial Crisis it has not been enough to fully close the gap between actual and potential production. The Output-Gap has remained negative in the last seven years and it is thus not surprising that inflationary expectations have remained low.

Without a true resurgence of global growth, deflationary forces are likely to remain present in developed nations. We are, however, skeptical that negative policy interest rates will be the magical elixir needed to prompt a spurt in global growth.

We believe that <u>the negative global output gap is more structural in nature</u> and maybe we should be revising our global growth expectations down. A new (lower) "normal" will be a bitter pill to swallow but one that seems more consistent with the data. <u>An absence of inflationary pressures is likely to persist into the foreseeable future.</u>

What does all of this mean for asset owners?

For most of my career the conventional wisdom was that higher inflation was bad for asset classes such as equities and bonds. But who would have thought that inflation rates would drop this far especially after the monetary expansion post Financial Crisis?



As with all capital market relationships the link between asset class returns and inflation rates changes over time.

At Global Focus Capital we employ a dynamic approach in modelling the relationship between key asset class returns and various macro-factors such as growth, sentiment, currency, credit and inflation.

Without delving into all the technical details of our macro risk management system let us instead focus on the latest output of the model. In particular, let us look at the role of changing inflationary expectations (in the US) on key weekly asset class returns.

The beta of an asset class to the change in US inflationary expectations measures the likely mean return of an asset class to a one percent change in inflationary expectations.

So what does the current data show? Some of the highlights include:

- For US Large Caps the likely impact of a 1 % increase in inflationary expectations is for a 0.7% return effect
- A similar effect would be expected for US Small Cap and International Developed Equities, but Emerging Equity Markets would benefit the most from an increase in inflationary expectations
- In general, <u>an increase in inflationary expectations would be good news for equity-oriented investments</u>
- Commodities would also benefit as would, to a lesser degree, real estate assets
- The opposite would be true for high quality fixed income investments. The beta for both US Bonds and International Developed Fixed Income is negative. Higher inflationary expectations would hurt bond market returns

As policy makers fret about how to revive global growth the implications for asset owners are profound.

Higher growth would lead to a ratcheting up of inflationary expectations which in turn would benefit owners of equity-oriented investments and likely depress the returns to high quality fixed income strategies.

Are short-term negative rates the answer? I don't know and I don't think anybody else knows with any certainty. It is still all an experiment with very much a trial and error feel.

What I do know is that the exercise creates a lot of uncertainty and absolutely punishes savers. The thirst for yield will likely get even stronger pushing investors to pursue marginally less attractive risk-adjusted exposures. The urge to speculate using borrowed money will prove irresistible to investors with a short-time horizon. These are some of the more obvious negative side effects of loose monetary policy.

I don't think that the long-term health of the global economy will improve with this form of shock therapy. Shock therapy approaches usually do not yield much beyond the initial high. Despite massive monetary stimulus the negative global Output-Gap of the last seven years highlights that impediments to global growth are likely to be structural in nature and that monetary stimulus has lost effectiveness.

I am naturally skeptical of using negative short-term rates except in the case of a real financial meltdown and only over short-periods of time! I don't think that global economies are in such bad shape to merit using this monetary experiment. Shouldn't we save the bazooka for when we really need it? Maybe the solution is to accept a new (lower) "normal" rate of growth and encourage policies to enhance global productivity and fully utilize our productive capacity.

Sincerely,

Eric J. Weigel

Managing Partner and Founder of Global Focus Capital LLC

Feel free to contact us at Global Focus Capital LLC (mailto:eweigel@gf-cap.com or visit our website at http://gf-cap.com to find out more about our asset management strategies, consulting solutions and research subscriptions.

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