INVESTING

Inflation, deflation and stagflation

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Our readers know that in our previous editions we've already talked about inflation and its negative effects on economic agents and the economy overall. Now that it's accepted that inflation is real and it is here, I would like to discuss all the concepts related to the general level of prices in the economy: inflation, deflation and stagflation. In order to be perhaps, more relevant, we will try to see how our discussion can be useful in the light of an investment portfolio with embedded measures to alleviate the risks involved.

As a reminder let's start with their definitions and for simplicity sake, I will use the same online source, Investopedia, to define each of them:

- **Inflation** is a rise in prices, which can be translated as the decline of purchasing power over time
- **Deflation** is a general decline in prices for goods and services, typically associated with a contraction in the supply of money and credit in the economy
- **Stagflation** is an economic cycle characterized by slow growth and a high unemployment rate accompanied by inflation

Let us start with the effects of inflation. It is widely accepted that high inflation is bad because it eats purchasing power hence it alters the standard of living of a given region or economy. Now that it is back, after a prolonged period of absence which was enabled by several factors such as globalization, innovation and productivity increase, we see that Central Banks have the tools and knowledge on how to fight inflation.

However, what about the other 2 possible economic conditions? Deflation and stagflation, are perhaps even worse than inflation. Using the definition, we can quickly see what can be a considerable problem in the case of deflation.

In the second half of the last century, there were many innovations such as credit cards which have contributed to the development of the credit industry overall. This in turn, helped create a consumer-based economy which is a significant part of the US GDP contribution today. The principle is fairly simple, the ample availability of credit gave the possibility to every consumer to spend more than earn. Hence, increasing demand which helped to fine tune the level of inflation through credit expansion or contraction.

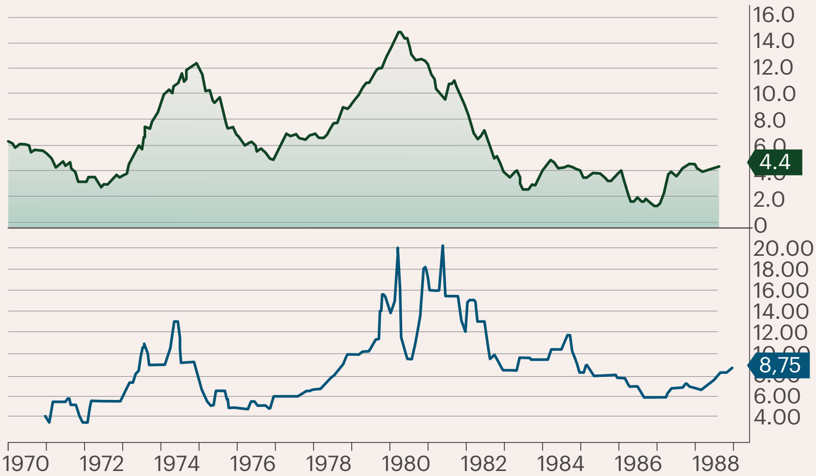
So, if deflation comes back, it implies a postponement of consumption which usually has an impact on credit and the result is a shrinking economic activity with heavy consequences. In the same time, most of the budgets, if not all, are built on the assumption that there will be growth. If there is no growth, then budgets are not balanced, because there are less revenues and less taxes which creates complicated situations for many economic participants.

In their paper, Ben Bernanke and Harold James (1990), study the concept of deflation in length, but for the sake of this article, I will put forward only a few excerpts:

- "Our focus, however, is on a channel of transmission that has been largely ignored by the recent gold standard literature; namely, the disruptive effect of deflation on the financial system"
- "However, we do not want to lose sight of a second potential effect of falling prices on the financial sector, which is "debt deflation" (Fisher 1933; Bernanke 1983; Bernanke and Gertler 1990). By increasing the real value of nominal debts and promoting insolvency of borrowers, deflation creates an environment of financial distress in which the incentives of borrowers are distorted and in which it is difficult to extend new credit. Again, this provides a means by which falling prices can have real effects."

In the above extracts from the paper, we see a few interesting points particularly relevant for our current environment.

Graph 1: US Consumer Price Inflation and Fed Funds Target Rate in the 70's and 80's
Source: Bloomberg, data as of 20/4/2024



In the US, the government debt is above 120% of GDP, the overall liabilities are estimated to be even bigger and the deficit published in March 2024 is -6.44%. You probably read about this in the media, but all of this is happening while there is strong employment, economic growth and the US is not a direct party to an important geopolitical conflict. These conditions are not sustainable according to history and in my view deserve closer attention. So, what are the possibilities that an investor may be contemplating?

The US is still the dominant world economic power, backed by its innovation capacity and a major advantage: the reserve currency status of the dollar. Given, their particular set of circumstances, the United Stated could manage their debt avoiding too much pain. However, the most prominent investors express their doubts (some have been for years). This leaves us with 2 options, either they do manage, in which case things could continue according to our current environment, or they will experience problems.

In the latter case, many changes may happen which will eventually lead to a devaluation of the dollar. Given the US Government wants to avoid a default at all prices, they will print money which is likely to cause inflationary pressures.

Stagflation is a tricky situation because when authorities seek to fight unemployment, several kinds of economic support are deployed which, in a period of inflation, can or even are inflationary which have an undesired side effect. So, the situation the Central Banks would like to observe is an inflation close to 2%.

The point is not to predict but to prepare for any potential outcome. I will end this paper with a few open questions:

- **What if, like in the late 70's there is another spike in inflation after the decline we witnessed?** AI will significantly increase productivity in many industries, but no one knows how big this will be. Usually, the expectations are too high in the short term, but… things may take more time to be implemented.
- **What if the US starts showing signs of a weakening currency?** Even, if there is not one single reserve currency, to replace the USD, there may be a basket of EUR, CHF, … for instance. In its book, "Business adventures", John Brooks goes through the GBP downfall when the British Empire started losing its glow, the Brits couldn't figure out who was attacking their currency. In the end, they understood that large international corporations were short selling GBP to cover their international operations in pounds which accelerated the fall.

With all the above being said, our team builds balanced portfolios that take into account the different outcomes. It is statistically demonstrated that what matters is the time in the market and not the market timing. •

Sources: The gold standard, deflation, and financial crisis in the great depression: an international comparison, Ben Bernanke and Harold James (1990), www.investopedia.com

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