

Rule of 3's

I invariably use deduction using the rule of threes which simply states that the first three factors driving any phenomenon normally cover 80% of the explanation of said phenomenon. In this vein, I wade into the raging inflation / deflation debate...

Inflation is the net sum of six numbers (according to my simple mental model), three of those numbers have traditionally been deflationary i.e. negative numbers, three of those numbers were traditionally positive numbers.

The net of these numbers is what we understand as the inflation as it exists in the economy.

These "flation" drivers are:

Traditionally deflationary

Globalisation / peace dividend / deregulation

Internet / disintermediation

Move to low cost labour

Traditionary inflationary

Demand pull / consumer spending

Cost push – rise in end product price due to cost increases

QE / money printing / artificially low interest rates – increase in kinetic energy of money via either the money supply or money velocity or low cost of credit.

The last 30 years have seen a preponderance of deflationary drivers which governments / central banks have effectively monetised by doing enough QE / money printing to make sure that we don't receive the benefits (yes benefits) of cheaper goods and services.

This they have trumpeted as a triumph of price stability. They were however, laying the table for a banquet of unintended consequences.

Hypothetical example:

Let's assume globalisation / deregulation was making goods and services cheaper by 3% p.a

Internet and the disintermediation of the middleman e.g. Amazon, was making goods and services cheaper, by 3% p.a.

Outsourcing to low cost labour countries was making goods and services cheaper by 3% p.a

That is 9% p.a. deflation (hypothetically)

Now we offset this with the inflation drivers...

Increase in consumer demand making goods and services 2% more expensive p.a.

Cost push? Negligible

So, five of the six drivers add up to 7% deflation.

QE / money printing / artificially low interest rate?

This is whatever central banks do to balance the sum of the six drivers so their average is around their 2% inflation target.

In this hypothetical example, the central banks could create out of thin air 9% of the money supply (velocity being constant) or credit and “appear” to be doing their job very well! i.e. price stability.

Now take the situation today...

Globalisation has reversed, geopolitical tensions have risen and deregulation has turned into reregulation. Let's say it is adding 3% to the cost of goods and services (conservatively).

Internet/disintermediation – already baked in. Contribution 0%

Move to low cost labour – reversed and now on-shoring has started. Contribution? +2%

Consumer spending – post Covid demand pull. Contribution +2%

Cost push inflation – China supply line clogging / wage spiral etc. Contribution +5%

QE / money printing – massive Covid QE spend and lowering interest rates. Contribution +5%

Total? 17% inflation.

The numbers in this example are not that important and likely wrong.

The main point is this...

In the past, we had three deflationary drivers off-set by three inflationary drivers leading to price stability which the central banks could easily manage by adjusting the last driver. i.e. QE etc.

Now ALL six drivers have turned positive leading to an unacceptable inflation rate of between 10-20%. Most central banks have responded in the time-honored way by reducing QE and raising interest rates.

This tends to drive consumer spending down, increases costs of goods and services (higher interest costs) and reduces money supply and availability and/or desirability of credit.

But to what extent? By the necessary 7-17% p.a.?

The pedestrian attempt at raising interest rates and reducing the central bank's balance sheet seems hardly enough to make a significant dent in the current inflation rate.

The net upshot of this is what I suspect - inflation will remain high enough for expectations to become unanchored. The Hounds of Inflation Hell have been unleashed and the central banks will not have enough will or stamina to get in front of it.

Of particular interest to us is Japan whose current CPI is 2.5%. They are an island economy who has to import most of its energy needs, raw materials etc.

With global inflation running realistically between 10-20% I do not see how they avoid importing a significant part of this global inflation.

The Bank of Japan is staying put at zero percent interest rates. Like King Canute who ordered back the waves of the sea and ended up being drowned by them, I see a similar global macro equivalent in Japan. The showdown at the O.K. Corral between Bank of Japan and CPI. If CPI prints in Japan are over 5%, which I see with a high probability, they either stand pat and watch their currency drop like a stone, or they blink and have to abandon zero interest rates in a hurry. Fortunately, there is an inexpensive option trade that cover both eventualities.

Like I always say ... often wrong but never in doubt. Either way it is going to get interesting!

The current thoughts by the “market” is that demand destruction combined with a reversal of QE / monetisation and higher interest rates will overwhelm the inflation drivers and drive inflation back towards 2%. I don't share this view.

Cost push inflation, beggar thy neighbor policies, China's Covid policies and stimulus, wage cost spiral and tightness of the labour market etc. etc. are more than enough to ensure we still have uncomfortably large inflation numbers in the presence of a recession. Classic stagflation...

Volatility generally is elevated from its extreme lows in 2018 / 19. Historically it is slightly above the long average in equities and slightly below in currencies. Given the super-cycle regime change in deflationary / inflationary drivers I fully expect this volatility uptrend to continue towards its cycle highs before dissipating.

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