BERMAN
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Inflation or Deflation?

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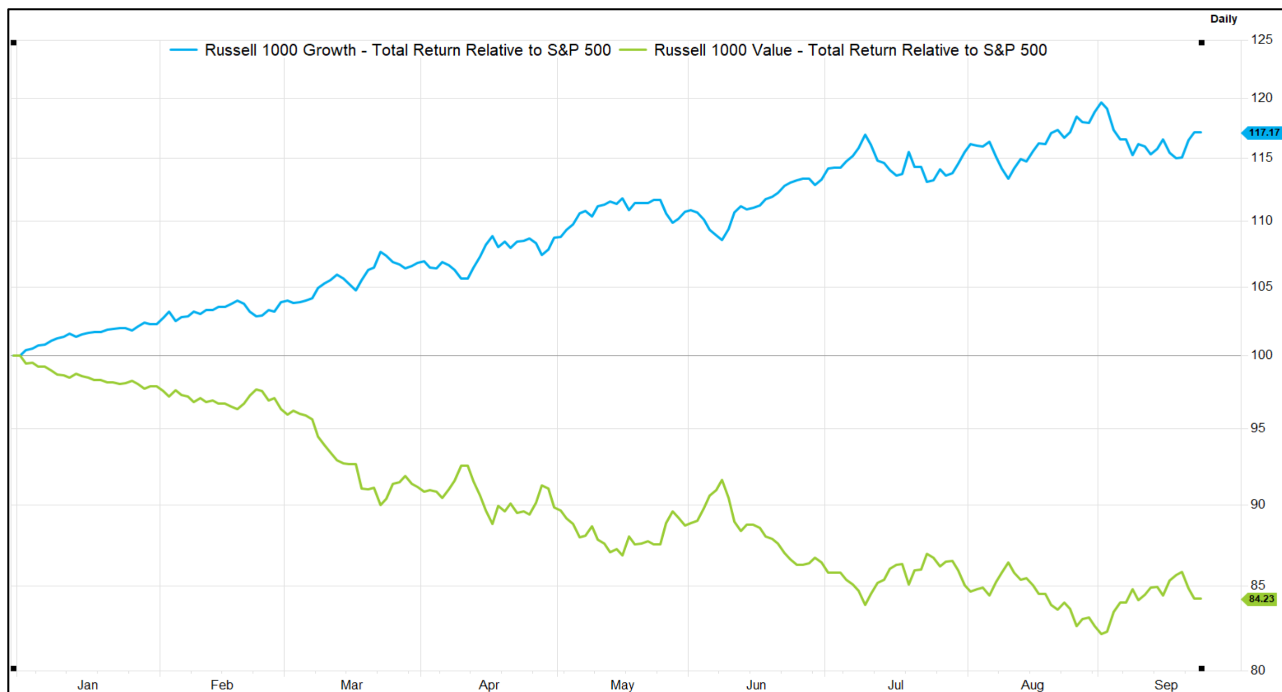
2020, to put it mildly, is shaping up to be a pretty tough year. Apart from politics, sickness and economic pain, movements in the financial markets have turned extreme and treacherous for short term traders. The pandemic and its repercussions created a sharp rise in long-dated Treasury bonds while crushing stocks across the board. Then a surprisingly quick government rescue response put a floor under stock market but revived some equity styles and sectors much more than others. Work from home plays, "compounder" stocks with steady growth and (perceived at least) highly defensive businesses, and high-growth tech such as electric vehicles and software stocks have absolutely dominated the market. As home to many of the mega cap technology names, the S&P 500 has fully recovered and is in positive territory for the year. The chart below shows the 2020 year to date performance (through September 22) of the Russell Large Cap Growth Index vs the Large Cap Value Index, both relative to the S&P 500. The valuation ratio of value stocks to growth stocks is now even wider today after an awful decade for value.



Given the current environment, these trends make logical sense on near term fundamentals. But ultra-low interest rates, and the conviction that they will be with us for another decade, are a critical piece of that story. The basic idea is that earnings in the future are worth more as the "discount rate" (the time value of money) goes down. For high tech companies with a great amount of growth expected in the future, lower interest rates have a large impact on current valuation. That said, this idea has almost certainly gone too far, as momentum for many stocks in the space has taken on a life of its own.

Since the discount rate in most stock valuation models depends on the 10-Year U.S. Treasury Bond yield, the move from 2% to about 0.65% is profound, especially if you believe it will stay ultra-low for years. As inflation expectations and the government bond yield go hand in hand, your view on this topic informs how you would want to invest in stocks. The key question to consider is: "Will the huge monetary and fiscal stimulus we have seen, and are likely to continue to see, generate inflation in the future? Or will we share the experience of Japan and potentially face a deflationary trap? "

Are We Japan? - Arguments for Deflation

Some economists believe very high debt leads to slower growth and less inflation, as consumers and businesses pull back, knowing the debt needs to be eventually repaid. In Japan, whenever rates rose slightly, debt service costs soared, pushing rates back to zero without any inflation.

Unfortunately, the hit from the pandemic means unemployment in the U.S. is likely to be high and stubbornly so in the coming years. This recession is larger than the Great Financial Crisis of 2008 and may take longer to fully reverse. Arguably, the Coronavirus has accelerated many technological trends that were already becoming prevalent, especially in technology and online commerce. E-commerce and the need for social distancing at least in the near term, mean enormous pressure on retail stores, restaurants/bars and most hotels. This shift will almost certainly result in permanent job loss and bring forward deeper automation. In turn this obviously will pull wage pressure lower. De-unionization and the rise of the gig economy may worsen this trend.

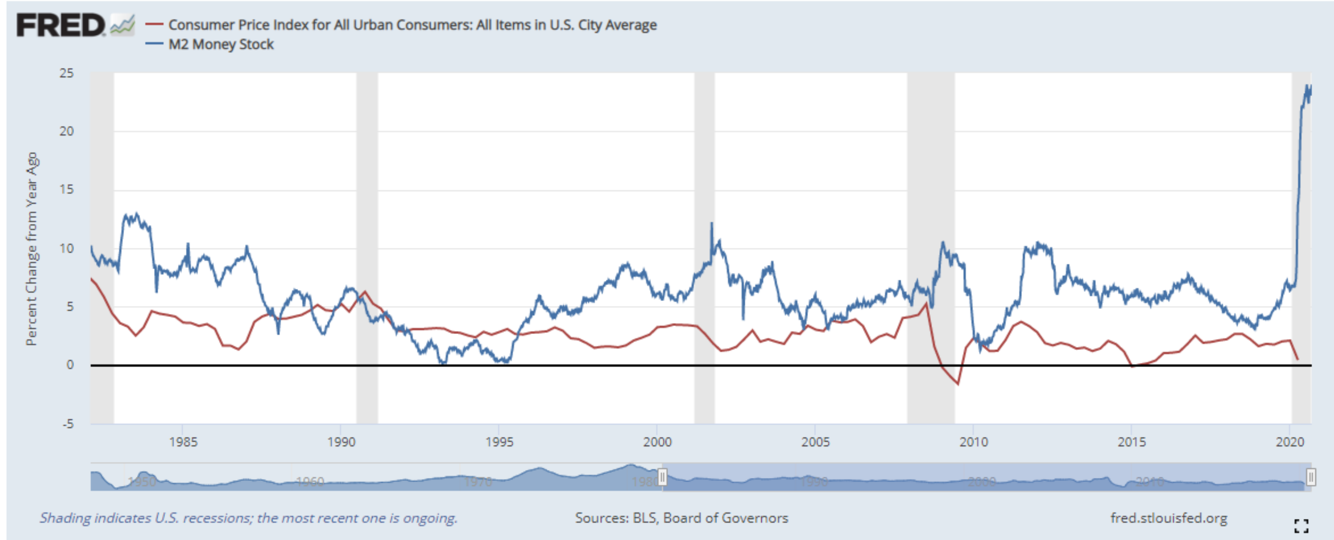
"Zombie" companies could be another source of deflation. With low rates as the dominant regime and pressure for banks to extend loans, more companies may remain in business than would otherwise be the case, keeping supply high and depressing profits. In Europe, some countries are taking other steps to keep technically insolvent companies going, to further prevent unemployment.

Demographics in the developing world are also likely to be deflationary. Coming out of World War II, the last time we had government debt so high, the U.S. enjoyed a burst of consumer demand, the baby boom and foreign competitors in shambles. We won't have that benefit this time around. The population is aging and needs to save for retirement, but with very low interest rates this may mean even more consumption is diverted to saving, further reducing demand.

The Counter Argument for Inflation

The two main channels for rekindling inflation are government actions and/or a surprising recovery boosted by pent-up consumer demand. Of these two possibilities, we think the shift in the government's actions likely will be dominant. These changes include policymakers' new, overtly tolerant attitude toward debt, policy changes at central banks, and the political imperative to inflate away the debt, as neither very high taxation nor rapid growth seem likely avenues.

The relationship isn't perfect, but rapid growth in the money supply does tend to result in inflation in the following years. It is true that the velocity of money has fallen sharply, but the size of the monetary creation is enormous, as can be seen on the chart below.



The Federal Reserve recently and dramatically changed its stance on inflation. At the Jackson Hole seminar in August, chairman Powell laid out policy that is now much more tolerant of inflation overshooting on the upside. Meanwhile ECB President Christine Lagarde has launched a strategic review of the bank's inflation targeting policy. It is expected that this review will see the ECB revise the inflation target up to 2%. Central bankers have not been able to meet their targets for years, and patience with this has worn thin in the context of high unemployment. Lastly, although controversial, Modern Monetary Theory (MMT) has entered the public discourse. In practice, it argues that debt doesn't matter, and that the government should spend whatever it takes to reduce unemployment. This influence has the potential to result in much higher inflation if it does become a reality.

Investment Implications

We do think the inflation issue is critically important for the role of bonds in an investment portfolio. Presently, our analysis points us in favor of the "no inflation" (at least as measured) camp. We are open minded to the possibility this really changes, but we think that real inflationary pressure is more likely further down the road, if at all. We still recommend a balanced portfolio and think that government bonds will still provide protection during panics and stock selloffs. We think it is still a growth stock market, although pullbacks on the part of highflyers, which we are seeing in September, should be expected.

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