The Investor and Inflation

Nobel Laureate Milton Friedman famously said: “Inflation is always and everywhere a monetary phenomenon, in the sense that it is and can be produced only by a more rapid increase in the quantity of money than in output”. The driver of that quantity of money is government spending priorities and in the 1970s, Friedman set out the path to ensure inflation could be kept under control.

The decade from 1973 through 1982 was the most inflationary in modern American history and elsewhere as the cost of living more than doubled. Adoption of the Friedman paradigm meant that inflation was brought under control and that the western world global economies have experienced several decades of low inflation since.

Benjamin Graham - “The Intelligent Investor”

Benjamin Graham’s book “The Intelligent Investor” is described by Warren Buffett as “by far the best book on investing ever written”.

In Chapter Two, Graham looks back at inflation since 1910. The first thing we notice he says “we've had inflation in the past - lots of it.” The largest five year dose was between 1915 and 1920, when the cost of living nearly doubled. This compares with the advance of 15% between 1965 and 1970. In between, we've had three periods of declining prices and then six of advances at varying rates, some rather small. “On this showing, the investor should clearly allow for the probability of continuing or recurrent inflation to come.” Graham then presents a table showing wholesale and consumer price rises, as compared to increases in stock earnings and stock prices. There is no clear alignment across these four columns.

He concludes that “it would be quite reasonable for an investor at this point to base his thinking and decisions on a probable (far from certain) rate of future inflation, of say, 3% per annum” He then considers whether one would be better to hold stocks over bonds, on the basis that stocks have a built in protection against inflation and asks, "are they not almost certain to give a better return over the years then will bonds?"

He notes the answer to these questions is somewhat complicated. Common stocks have indeed done better than bonds over a long period of time in the past.

He concludes that "There is no close time connection between inflationary conditions and the movement of common stock earnings and prices... there are contradictions in both directions in the record of previous five year periods"

It was generally felt that "a little inflation" was helpful to business profits.

"This view is not contradicted by the history of 1950 - 1970, which reveals a combination of generally continued prosperity and generally rising prices. But the figures indicate that the effect of all this on the earning power of common stock capital (equity capital) has been quite limited; in fact it has not even served to maintain the rate of earnings on the investment. Clearly there have been important offsetting influences which have prevented any increase in the real profitability of American corporations as a whole. Perhaps the most important of these have been (1) a rise in wage rates exceeding the gains in productivity, and (2) the need for huge amounts of new capital, thus holding down the ratio of sales to capital employed. The figures indicate that so far from inflation having benefited our corporations and their shareholders, its effect has been quite the opposite."

The earnings and average annual market value of a stock portfolio will not grow at a uniform rate of 4%, or any other figure. In the memorable words of the elder JP Morgan, "they will fluctuate".

In the commentary to Chapter Two, a table is presented, which leads the author to conclude, "When inflation is moderate, stocks generally do well. But when inflation heats up to very high levels, stocks perform erratically, often losing at least 10%".

COVID Inflation

The inflation that is currently being experienced in the western world is an example of risk failure. When risk management templates are formulated, most systems are able to deal with one or two risks at a time without inappropriate outcomes. It is when three, four or five things go wrong at once, that there is a risk of catastrophic failure.

Regrettably, that is what has occurred with COVID inflation. The threat of a global pandemic has been in the psyche for the last 100 years since the Spanish Flu in the early 1920s. The COVID-19 pandemic originating in China caused considerable angst across the world, as the pandemic that many had feared would recur over the last century. That pandemic in turn led to global supply shortages and interruptions to supply chains. This was the second order issue which occurred as businesses moved from just-in-time to just-in-case or not-at-any-time. Ordering was haphazard and lead times variable, freight rates escalated by hundreds of percent and businesses were severely disrupted.

The third order effect was that governments introduced fiscal policies to stimulate the economies. These policies were initially appropriate, but they continued too long in several countries including Australia which ultimately led to overstimulation with the increase in money supply. Just as central governments did not sufficiently curtail their stimulatory spending when it became clear that modern medical science was producing effective vaccines, the central banks globally jumped on the bandwagon and reduced interest rates to near zero. Again rather than hold back when it became clear that vaccines would result in COVID being a health event rather than a systemic event, central banks went all out with quantitative easing (QE) of a kind not seen in our lifetimes. This consisted of buying longer dated bonds at higher prices, so as to keep longer term bond rates low. The fiscal spending was the third order effect, but it was the monetary over-stimulation as the fourth order effect that your diarist believes caused the major boil over with inflation.

The central bankers all appeared to be talking to each other, because their statements around the western world were similar. For example, at one point were told inflation was transitory. We were told that taking interest rates to zero was fine because there was a new economics called Modern Monetary Theory (MMT), which held that you could stimulate the economy, and not worry about the money supply and do so until unemployment reached decade lows. In fact, central bankers told us that this was a once in a lifetime opportunity to have unemployment reach levels which most would have thought would create excess demand for labour and inflation. Indeed this is the fifth order effect and the major ongoing issue.

Goods inflation had largely been kept in check by competition over recent decades, because it is hard for businesses to increase the price of goods, when shoppers can go online and buy goods at discounted prices. Goods inflation which blew out quickly, has been brought under control to a large extent, including incidental costs such as freight which have returned to pre COVID levels. But the monetary stimulation together with the cash saved during the fiscal expansion means that spending on services has continued and labour in the services industries is in short supply.

So what does this mean for investment?

Prior to COVID, US stock market valuations were looking stretched, particularly in the technology heavy NASDAQ Index. The Burrell central case was for a correction in these valuations over time similar to the 2000 tech bubble. During calendar 2022, the Dow Jones Index corrected 20% and the NASDAQ by 30%, with four bear market rallies in the second half of the year, but closing on the lows at December 31, 2022.

Calendar 2023 in the US has been a little surreal. If one were to look at the markets, it might be concluded with the strong rallies in US indices that all the bad news is behind us and life has returned to pre 2019. In fact, many thoughtful commentators including your diarist are of a contrary view.

In terms of valuations, the increase in the 10 year bond rate, often referred to as the risk free rate, means that, all other things being equal, stocks should be worth less rather than more as future cash flows are discounted at higher rates and equity returns need to reset to be a risk adjusted margin above corporate bond returns. It should be noted that the Australian stock market has not had the phenomenon of technology and GAAP (growth at any price) stocks of the US, other than in a minor way. Thus the central case was and continues that the US markets should adjust by considerably more than the Aussie battlers, which, as with the technology bubble in 2000, continued on a gently sloping upward trend.

But the US has advantage in two areas. Firstly, their mortgage market is quite different, they don't have the so called interest rate cliff in Australia caused by the RBA lending funds to banks at low interest rates, who in turn on lent for low interest rate mortgages. Secondly, the US does not have central wage fixing. This means that the wage price spiral caused by the automatic inclusion of consumer prices into wages is not such a feature.

The conclusion that your diarist reaches from the above thoughts is that it is more likely than not that this period of inflation, being a period of high inflation, is more likely to cause negative stock market returns than positive stock market returns. The rapid increase in interest rates globally is being seen at the retail level, albeit only markedly since April 2023. The inflation impacts are continuing to have adverse consequences. e.g. with escalating failures in the building and construction industry, as their mode of doing business using fixed price contracts leads to business failures. Significant parts of the economy appear to be able to raise prices. e.g. travel as Australians look beyond the hardware store to restaurants and travel, post COVID. While we can but hope that inflation will come down, your diarist was always taught to make sure that the inflation Genie didn't get out of the bottle, because it was very hard to put him back in.

Summary and Conclusion

The above analysis of inflation indicates that we have a risk management failure with respect to the economic management of inflation caused by a number of risk failures. It is therefore time to be careful of high valuations e.g. price/earnings ratios over 20 with low growth, to be careful of technology and growth at any price stocks, to be careful of balance sheets with high debt and to be careful of non-investment grade fixed interest securities promising overly high interest rates.

On the other hand, companies with sound balance sheets and business models, which are able to pass on to a reasonable extent inflationary costs and with sales not highly dependent on retail spending, these should be the focus points for ongoing dividends and capital preservation.

Happy investing,

Chris