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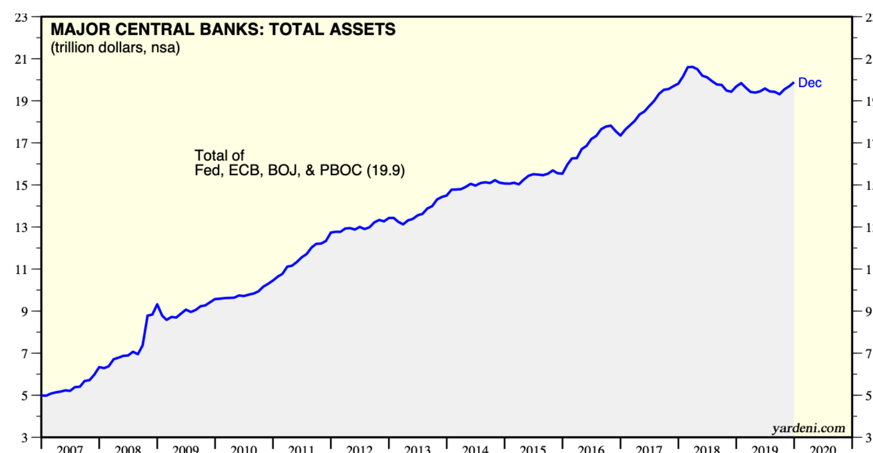
Prospector Partners Quarterly Commentary

An Inflation Discussion

"Economic medicine that was previously meted out by the cupful has recently been dispensed by the barrel. These once-unthinkable dosages will almost certainly bring on unwelcome aftereffects. Their precise nature is anyone's guess, though one likely consequence is an onslaught of inflation."
– Berkshire Hathaway's 2008 Annual Letter

Mr. Buffett's prediction for an "onslaught of inflation" has been a false narrative. Over a decade later, economic medicine that was once dispensed by the barrelful is now dispensed by the truckload. Since the crisis, balance sheets of major central banks have more than doubled, negative-yielding debt is now a reality to the tune of $17 trillion, and the global monetary policy rate index remains unchanged.

When Mr. Buffett made his statement, central bank assets were a mere $9 trillion:



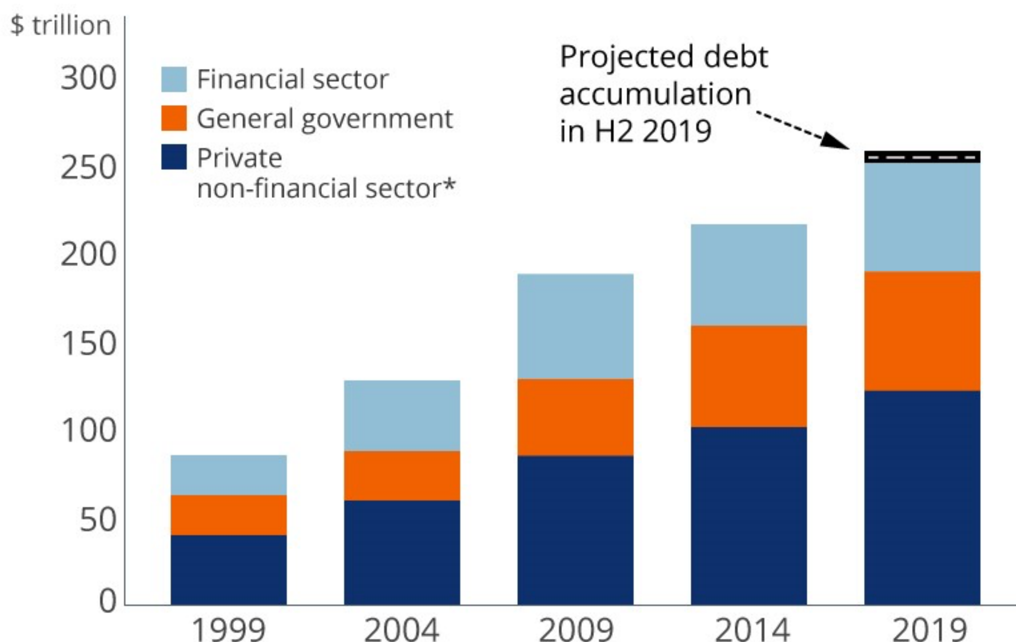
Source: Haver Analytics, Yardeni Research

Despite a surge in stimulative measures, below-target inflation remains an issue. This is understandable given demographic trends of an aging population and low population growth, a slowing global economy, a weak manufacturing sector, Brexit uncertainty, and the trade war. Even the once hawkish Fed is concerned that the United States could be at risk of entering a period of sinking inflation, zero rates, anemic growth, and the exhaustion of accommodative monetary policy (similar to what Japan and Europe have experienced). If a progressive candidate is elected in the 2020 Presidential Election, these fears should be exacerbated as Republican tax cuts may be rolled back along with pressure on corporate profits and economic activity.

However, the United States is somewhat better positioned than peers to combat deflation going forward. We have monetary "ammunition" in the form of additional rate cuts and quantitative easing measures, while the Eurozone and Japan have few policy tools remaining. Additionally, the United States faces demographic headwinds in the form of an aging and shrinking work force as a percentage of the population – but these headwinds are less versus what Japan, South Korea, China, and parts of Europe are facing. Plus, we have relatively higher positive population growth aided by both a higher birth rate and a better immigration rate. Finally, the United States remains the premier market for business activity given robust and enforced business laws, accessible and diverse capital markets solutions, pro-business policies, and high workforce productivity.

Given that policy makers are focused on fighting deflationary pressures, the outlook for a significant acceleration in inflation seems remote. However, there are multiple reasons why inflation could accelerate over time. In an effort to spur the economy, policy makers have embarked on an unprecedented campaign of quantitative easing, a tool which is inflationary in nature. Additionally, stimulative economic policy has pushed global debt to $255 trillion, which has roughly doubled since 2004. All else equal, high debt levels lead to high inflation. Another argument is governments will accelerate inflation to lower the present value of debt to facilitate de-leveraging. Finally, continued progress in trade negotiations, full employment, and a rebound in global growth may accelerate the pace of inflation.

Global debt by year:



Source: IIF, BIS, IMF, Reuters

While these arguments are rational, the reality of today's low inflation environment is perplexing. So, is Buffett's prediction for "an onslaught" of inflation invalid given the passage of time? Have astute policy makers undertaken a massive campaign of unconventional monetary policy with no consequences?

We don't think so…

The transition to an inflationary environment may require an exogenous shock. The shock could come from a recession, credit crunch, escalation of the trade war, political change viewed as negative for the economy, conflict, black swan events, etc. In our view, one or more of these scenarios has a modest chance of occurring in the coming years given where we are in the economic cycle and the political climate. For example, if a recession occurs, we'd expect debt levels to meaningfully increase as automatic stabilizers such as lower tax rates, unemployment insurance, and higher use of government assistance programs such as Medicaid take hold. Fiscal spending would be used to stimulate the economy which would push debt even higher. Central banks will use what little "ammunition" is left and governments may attempt to devalue their currency in order to spur growth.

In the end, economies (perhaps our own) may be left with higher debt levels, weaker currencies, and the exhaustion of policy options. A potential result is eroding faith in the fiscal / monetary situation. Individuals might then assign a discount to our currency (i.e. require more dollars per transaction), which would be inflationary in nature. Additionally, the real cost of capital could then increase.

Assuming the inflationary pressure isn't extreme (e.g. what the United States experienced in the 1970's), we believe this scenario may be positive for the global economy despite the short term pain of an exogenous event such as recession. Over the long run, the present value of debt should decline meaningfully and policy makers would gain valuable "ammunition" by hiking rates and shrinking their balance sheets to curtail inflation. This should give individuals greater faith in the underlying fiscal / monetary position – thereby improving the economic outlook and the movement of inflation to a lower and healthier level. The labor force might also benefit in the long term as businesses substitute higher cost capital for labor which will drive wage growth.

We hope the unwinding of the global debt burden and central bank balance sheets will be manageable. That said, there are bound to be casualties from such a shift. Investors heavily weighted in cash and fixed rate assets will suffer in an inflationary environment. Additionally, there will be a large swath of companies whose fundamentals and share prices would deteriorate under this environment.

Our Ready Inflation Playbook

While we don't expect a jump in inflation over the short / medium term, inflation can "creep-up" unexpectedly. Thus, we remain vigilant and contemplate how we should adapt to potential scenarios as they emerge. Should we enter a period of rising inflation, we believe the following would be beneficiaries:

- Companies who employ productive capital assets that produce goods and can exhibit pricing power to mitigate the cost pressure of inflation. These companies can be found in the consumer staples, technology, industrial, and energy sectors.

- Healthcare companies: healthcare is an essential product and service which must be consumed. As a result, providers of healthcare should be able to pass a significant portion of costs borne by inflation to the consumer.

- Companies that would benefit from a return to pre-crisis yield curve normalcy. Examples would include asset sensitive business banks, insurance companies, financial exchanges, and asset managers.

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