**Strategy Thoughts**

**February 2016**

## The Challenge Continues

## As the threat of Deflation grows!

### Introduction

I ended last month's edition of Strategy Thoughts with the observation that 2016 'may well prove to be a most challenging year', and given what has already occurred this certainly seems to be the case. Equity markets throughout the world have trended lower; in Europe the Euro Stoxx 50 index has already lost 15% and is now down more than 25% from its high in April of last year, in the US the broad S&P500 has already slipped 10% this year and the small cap Russell 2000 index has lost 15% so far in 2016 and like the European index is down 25% from its 2015 high. In Japan the Nikkei has also fallen 25% from its high of last year and is already down 12% in 2016 and the Australian ASX index has lost 6% so far this year and nearly 20% over the last eleven months. Other asset classes have not fared well either with the high yield bond market extending its fall from last year with the ETF JNK falling 5% year to date on top of the 25% it lost in the second half of last year, and commodities have fared poorly too with the CRB index slipping 8% year to date and 28% over the last twelve months. Capturing just how miserably the year has started is the index that caught the attention of so many eight years ago through the GFC, the Baltic Dry Freight index. This index has so far fallen more than 35% and is down a staggering 75% since August of last year.

Remarkably, despite this widespread misery in markets, hope persists and so the slide down the 'slope of hope' looks set to continue.

In this month's Strategy Thoughts I will examine the 'slide' and the 'hope', but perhaps more importantly I will revisit a subject that has concerned me for a number of years now, deflation.

### The Slope of Hope

I have written about the psychological shift that occurs in investors when a bull market turns into a bear market, and vice versa, many times over the last sixteen years but it still warrants re-examining and repetition as our 'herding' and 'anchoring' biases can easily overwhelm any lessons we may have thought we learned at previous turning points. Or, as George Bernard Shaw is attributed as saying;

> "We learn from experience that men never learn anything from experience."

The crescendo of the 'climb up the wall of worry' is reached when investors have determined that there is in fact nothing at all to worry about, no matter what challenges are identified they choose not to worry and extrapolate nothing but a wonderful enriching future ahead. Once the market rolls over they continue to be filled with hope and optimism. Any sell off is usually described as somehow 'healthy' and a great buying opportunity for long term investors. Despite the falls that have been seen across asset classes so far this year currently this seems to be the prevalent attitude. *Forbes* in late January pointed out that there may be some 'confusion' given how markets are behaving;

**The Stock-Market Correction Has Stock-Market Pundits Rather Confused**

> Whatever the answer it seems folly amid a stronger dollar, falling commodities and gridlock in Washington to bet against the American economy. This is the stuff of booms, not recessions. Assuming the electorate gifts voters with a boring November election outcome, patient investors will be rewarded for not exiting amid the Trump/Sanders correction.

But their conclusion was very clear, the current backdrop supports economic booms, not recessions, and patient investors will be rewarded. It is undoubtedly true that over the extremely long term (sometimes decades!) eventually long term investors are rewarded but sadly very few if any long term investors remember that they are long term investors as the pain, suffering and self doubt grows as the bear market progresses.

Time.com's money magazine, also in late January, gave investors a similar 'long term' comforting message to get the point across that investors should actually love it when the market drops;

## 3 Reasons Not to Worry About the Market in 2016

- From a long-term perspective, I really don't care what the market does, and neither should you.
- Over the past 30 years, the S&P 500 has produced average total returns of about 9% per year.
- "The market" and "your stocks" are different concepts

The same magazine had reassured investors in mid January, under the headline;

**The Stock Market Just Fell 10%. Should You Rebalance?**

Apparently such rebalancing in the long term was not really that vital, what was vital was not to panic and stay the course.

The same line was being taken in the southern hemisphere where *The Australian* and *The New Zealand Herald* carried almost identical stories to answer the question of whether corrections are normal things for a market;

> Stock market corrections have historically happened every 18 months. The August correction was the first in nearly 4 years, an unusually long gap. Even the most bullish of market strategists say a correction is ultimately healthy for a market because it removes some of the froth and speculation, and allows investors to buy stocks at more reasonable prices.

The theme was the same, corrections are healthy, and doesn't that last phrase '*it removes some of the froth and speculation, and allows investors to buy stocks at more reasonable prices's s*ound sensible, calming and reassuring. These were all similar to the measured and calming 'healthy correction' comments that filled the media in late 2007 and early 2008. But apparently we should not even be thinking of such a parallel as CNBC clearly stressed in early January;

## This isn't like 2008—but a correction IS coming

The article concluded with again the calming and measured advice;

> This is not 2008, it is a cyclical correction in a long term bull market. Be ready to put money to work as stocks go on sale throughout this year.

Unfortunately there is often more wisdom in cartoons than in the quotes from the supposed 'experts' who often have a vested interest in maintaining their levels of funds under management;


One of the major 'hopes' that persists, despite mounting evidence to the contrary, is that a deflationary rout will be averted by skilled central bankers, an idea that a few long time readers may, like me, consider an oxymoron given their track record!

**Deflation**

I first started to warn of the dangers of a deflationary downturn after reading economist A Gary Shilling's late 2010 book 'The Age of Deleveraging', a title I used for the February 2011 edition of Strategy Thoughts in which I strongly recommended the book.

The long term outlook presented by Shilling in 'The Age of Deleveraging' was one of slow global growth for many years to come, even in the developing world that he maintained was highly dependent upon the developed world, and particularly the American, consumer.

The nine causes for this slow growth outlook were;

1. US consumers will shift from a 25 year borrowing and spending binge to a saving spree. This will spread abroad as American consumers curtail the imports of the goods and services many foreign nations depend on for economic growth.

2. Financial deleveraging will reverse the trend that financed much global growth in recent years.

3. Increased government regulation and involvement in major economies will stifle innovation and reduce efficiency.

4. Low commodity prices will limit spending by commodity producing lands.

5. Developed countries are moving toward fiscal restraint.

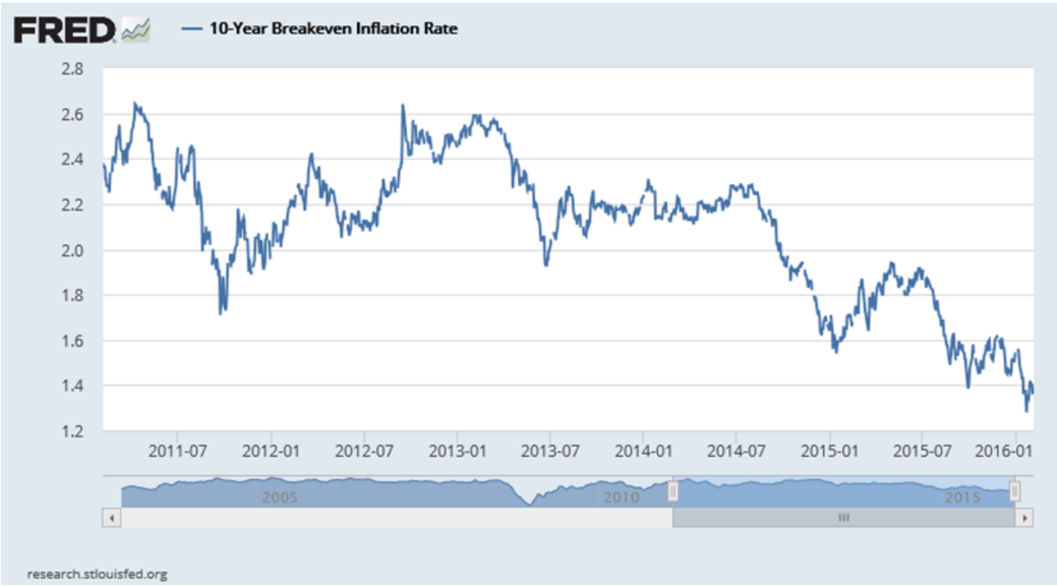
6. Rising protectionism will slow, even eliminate global growth.

7. The housing market will be weak due to excess inventories and loss of investment appeal.

8. Deflation will curtail spending as buyers anticipate lower prices.

9. State and local governments will contract.

Over the last five years things may not have unravelled in exactly the manner Shilling foresaw, or perhaps as rapidly as he predicted, but they have continued to unravel and inflationary expectations have been consistently cut to the point that now the fear of outright deflation is real with inflation rates having fairly consistently, and at times quite dramatically, declined;




However, deflation was far from being acknowledged as a real risk back in late 2012, particularly by central bankers. In October of 2012 CNBC ran the following headline;

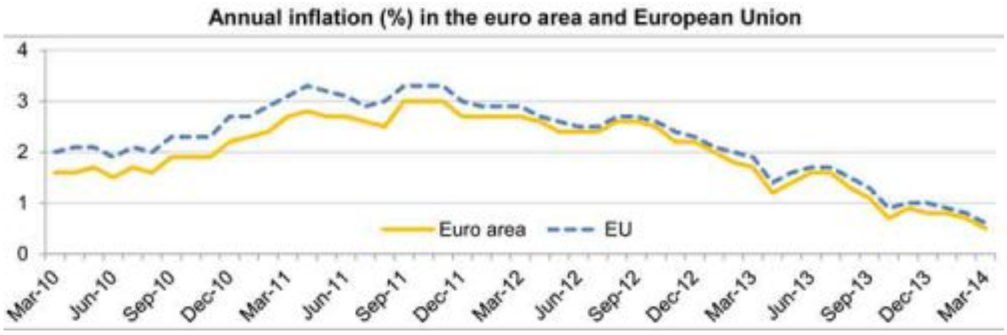
**Fed's Lacker: Latest Stimulus Will Boost Inflation** **Friday, 26 Oct 2012**

If there was any 'boost' to inflation as the article forecast it was clearly short lived.

In May 2014 I wrote that the still vociferous chorus of deflation deniers was surprising given the increasing evidence of deflation emerging. In that edition of Strategy Thoughts I included the following headline from *The Daily Telegraph* and a couple of charts;

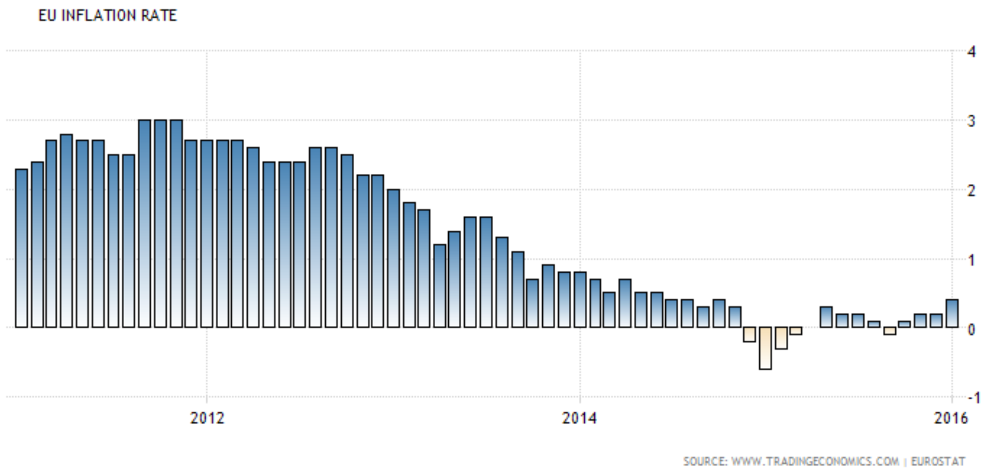
**Eight EU states in deflation as calls grow for QE in Sweden**

**Sweden's Riksbank admitted in its latest monetary report that something unexpected had gone wrong**





Since then the prospect of deflation has only increased as this slight longer term and updated chart of EU inflation shows;




One month later, in June of 2014, I continued to highlight the growing deflationary threat and the increasing levels of fear that were appearing;

**Bond Yields Lowest Since Napoleon Are No Comfort to Europe Amid Deflation Fight** (Bloomberg June 4)

**Eurozone deflation fears add to pressure on Draghi** (the FT June 3)

**Deflation fears grow** (Irish Independent 31 May)

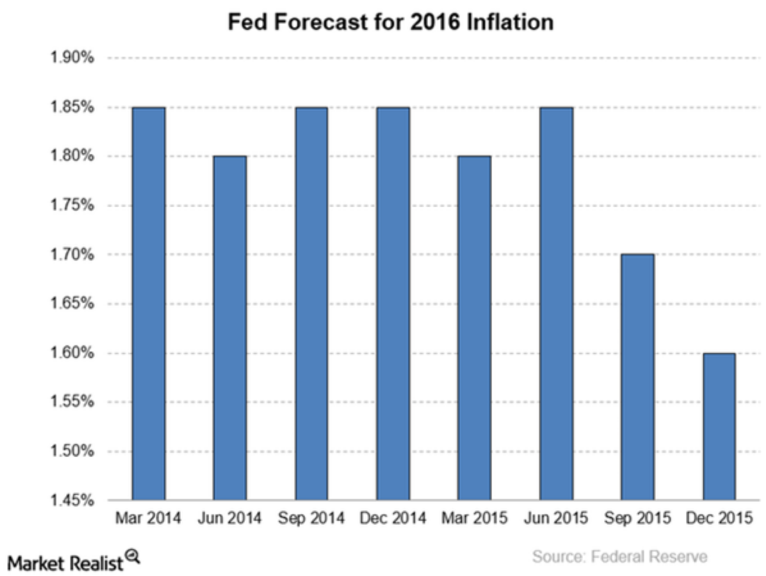
**China deflation fears as price rises slow sharply** Economists warn "risk of deflation is looming" as consumer price rises slow to 18-month low

As recently as last November I continued on the same path. The Wall Street Journal seemed surprised that inflation rates continued to disappoint, but were still dismissive of the possibility of deflation;

> Global Inflation Eased in September Despite Wave of Stimulus Measures
>
> Policy makers regard slide into deflation unlikely, but it would be highly damaging should it occur

Since then the prospects for outright deflation have only continued to grow and on January 8th Yahoo finance reported;

**The Fed keeps taking down its inflation forecast**




But the Federal Reserve cutting their inflation forecasts is nothing new, they have been doing it for years. In January 2012 they forecast that 2014 inflation would be 1.6% – 2%, by September these numbers had been trimmed to 1.5% - 2%. In March of 2013 they were trimmed again to 1.4% - 2% but by December of 2014 their forecast was narrowed and reduced to 1.2% - 1.3%. A similar pattern can be seen for every Fed inflation forecast over the last five years as the Yahoo article referenced above described;

> In September 2013, the Fed forecast that 2015 inflation would be 1.6%–2%. It ended up coming in at 0.4%. The Fed had been consistently too high on its inflation projections.
>
> At the December meeting, the Fed took down its 2016 inflation forecast from 1.7% to 1.6%. The stronger dollar is affecting commodity prices and imports, and that's keeping a lid on inflation.

The Fed's long term target for inflation in all these forecasts has consistently remained at 2% despite actual inflation having not been close to 2% for several years.

Even if the Fed continues to believe that somehow, sometime in the future, inflation will return to their long term target of 2% the risk of deflation are being increasingly discussed as the following from *The Sydney Morning Herald* on January 12th illustrates;

# Deflation a serious threat to investors

The article began;

> Deflation is the "most likely" scenario for most of the developed world, according to a gloomy note from Sydney-based Clime Asset Management, while Fidelity and HSBC have also echoed their concern about the spectre of falling prices.
>
> Clime said the outlook for the world's developed economies was one of lower growth and low inflation.
>
> "We would therefore speculate that the most likely economic scenario for most of the developed world is deflation. A re-run of Japan's decades of low growth but on a grander worldwide scale."
>
> Deflation is characterised by falling prices, as opposed to inflation, which is defined as rising prices. Economists consider deflation a threat because it increases the real value of debt and may aggravate recessions through a deflationary spiral.

Commenting on the increasing evidence of deflation in Europe *The Wall Street Journal* wrote;

## Eurozone Inflation Remains Stubbornly Low

It is proving more difficult for the ECB to boost inflation than policy makers expected

The article stated that;

> ECB President Mario Draghi said at the time that he expected inflation to start to pick up "at the turn of the year," and continue to move toward the central bank's target of just under 2% in 2016 and 2017.
>
> Economists continue to expect that the annual rate of inflation will rise in the early months of 2016, but less sharply than had been thought likely.

But there exists a horrible danger as the article concludes;

> But the ECB views very low rates of inflation as a longer-term threat to the eurozone's economy, since it makes it more difficult for governments, households and companies to reduce the high levels of debt accumulated in the run up to and in the aftermath of the financial crisis, weighing on demand for years to come.
>
> They also fear that at very low rates of inflation, **a fresh shock that weakens the economy could push the currency area into deflation, a chronic condition in which falling prices lead households and businesses to postpone pur**chases in the hope of getting a better deal, which in turn cuts output further. (emphasis added)

It is not just a European or American issue either, three weeks ago *Barron's* ran**:**

**South Korea's Warning Signals Flashing Caution**
The central bank is upping pressure on the Park government to stimulate growth as deflation looms

The article went on to point out that that the BoK had trimmed its inflation forecast to 1.4% from 1.7% and that the **deflation** worry was growing.

Early in February*, theweek.co.uk*, commenting on the Bank of England's decision to maintain interest rates at a record low level wrote;

> Behind the more cautious message – a far cry from governor Mark Carney's hint last year that rates could rise in the early part of 2016 – are growing concerns over the economy. In the inflation report issued alongside today's announcement, the Bank downgraded its forecast for wage growth, economic growth and inflation over the next three years as global storm clouds gather.

Not surprisingly I continue to worry about these growing storm clouds.

**Conclusions**

Despite the increased coverage that the growing threat of outright deflation is getting my concern continues to be that if there is a surprise or a disappointment on the horizon regarding inflation or deflation it is more likely to be a disappointment. Central bankers will likely continue to lower their expectations for inflation and may even have to reduce their long term targets. In such an environment the challenge, as outlined in this month's introduction, will continue, as will the slide down the 'Slope of Hope'. It is important to remember that the bottom of that slope is not reached until expectations are so grim that any news, no matter how bad it may be in an absolute sense, is less miserable than feared and so delivers a surprise. At such a time don't expect central banks to still be forecasting positive inflation rates.

Given this outlook I continue to favour focussing upon capital preservation and not chasing yield.

**The expectations game**

Four weeks ago in the January edition of strategy Thoughts I briefly mentioned that I had begun work on a new book. Since then the majority of my time has been spent writing **'INVESTING - How to win the 'The Expectations Game' and Why Most Investors Fail'**. To date I have written a little over 25,000 words and believe that this first draft may be close to 50% complete and our aim is to have the book available mid year. The following extract from the introduction should give readers something of an idea of what the book will deliver;

> This book's primary aim is to highlight the value of simplicity and the danger presented by complexity in investment. As a result the reader will be presented with a very different way of thinking about the simple act of investing.
>
> Importantly there are a few of things that this book is not. Firstly, it is not intended to be a step by step 'how to' guide to investing. There are hundreds, if not thousands, of such books available and sadly, like diet books, as the results for even professional fund managers

demonstrate, they clearly don't deliver what is wanted or needed. Secondly, it is not an economics text book. Economics and investing seem to be inextricably linked in the mainstream media and many see the route to better investment results in being a better economist. However, nothing could be further from the truth, economics and economic forecasting have been the root cause of far more investment failures throughout history than investment success. Finally, this book will not provide an investment 'answer' based upon complex theories, formulae or models. There will be absolutely no reliance upon 'efficient frontiers', 'Monte Carlo Simulations' or any other of the myriad complexities and acronyms that are continually thrown at the investment conundrum.

The book will be quite a different investment book and, as the title implies, will guide readers in how to look at investments and think about investing through an expectational lens. I would like to thank all those readers who have already expressed encouragement and enthusiasm for this project and would naturally welcome any further interest. I will keep readers updated as the project progresses.

**Recommendation**

www.trumpthemovie.com

Anyone who was involved in the markets, and particularly in New York City, as I was in the eighties will love this movie. They almost certainly wouldn't have voted for Trump anyway but this seals the deal as the entire movie repeatedly asks challenging questions of Mr Trump's character.

Kevin Armstrong

10th February 2016