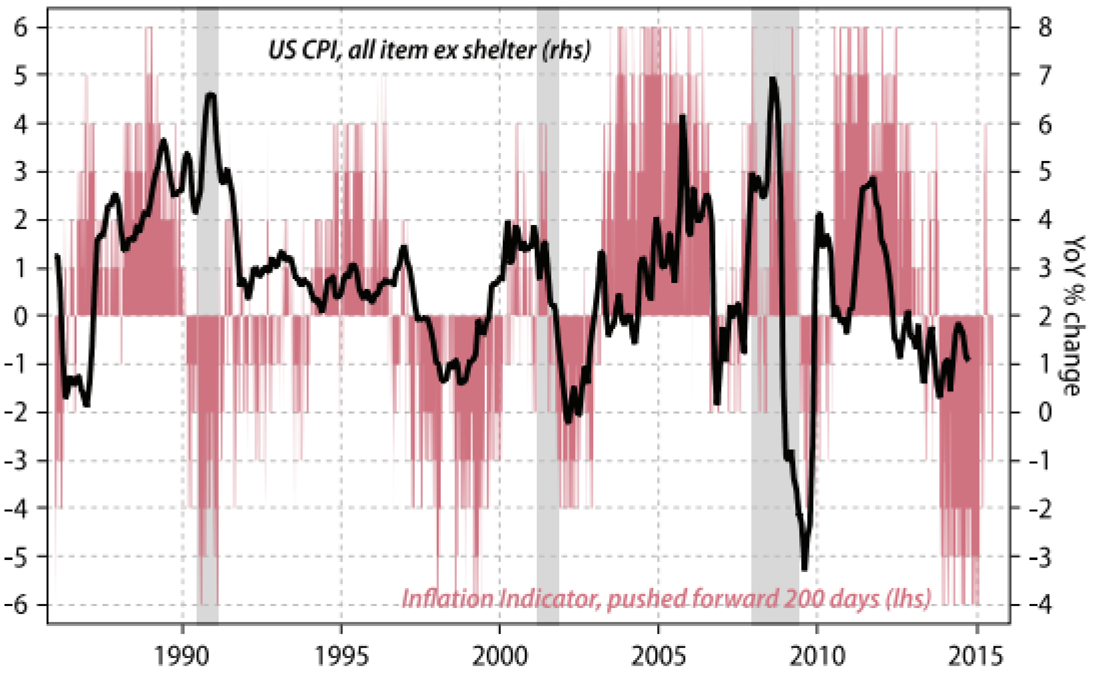
Deflation: Boom or bust?

Charles Gave | GaveKal | 05 November 2014

It has been my contention for a while that capitalism is returning to its 19th century deflationary roots. Indeed, the evidence for this assertion has become overwhelming. The consumer price indices of 13 OECD countries have negative YoY readings. Another eight are below 1%. In the case of "goods inflation" all European economies are flashing negative. And if the likes of Italy or Spain thought that salvation lay with an "internal devaluation" they can think again as Germany's producer price index is negative. Even the US CPI ex-shelter is only inching along at about 1% YoY (I remove rental costs as these are largely imputed values not based on actually transacted prices).

My own leading indicator of inflation, which is largely based on actually transacted prices, is plunging again (Figure 1). This indicator has tended to lead falling or decelerating prices by about six months. The index tends to be highly correlated to world trade and, worryingly, it has broken down in recent days. My assumption is that world trade will fall in volume terms, with declining prices to boot.

Figure 1: P Indicator & CPI ex-Shelter
Shaded grey: US recessions



Sources: Gavekal Data / Macrobond

But what exactly is the driver of these deflationary forces? As outlined in our book Too Different for Comfort, we see three big factors:

1. The advent of new shale oil and gas technologies is leading to lower energy prices. This is "good deflation" which can be thought of as a tax cut. The unknown factor is the amount of US dollar debt that has been incurred to develop resources which may become unprofitable at much lower prices. In this case, plenty of borrowers could go bankrupt - which is hardly good news. Indeed, the aftermath of the 1985 oil price plunge saw bank failures in Texas and the Lone Star state's economy struggled for years afterwards.

2. Productivity enhancements tied to accelerated automation and the spread of robotic technology is having a profound impact. Robots used to do simple and repetitive tasks. Now they do smart and repetitive things such as surgery. The worry for the middle class in most advanced economies is that their jobs mostly involve doing intelligent and repetitive tasks. The good news is that the price of surgery will go down. The bad news is that many surgeons will be out of a job. This is classical creative destruction but this time, it's hitting professionals.

3. Intense pressure is also to be seen in capital-intensive manufacturing industries that are still heavily represented in advanced economies - that is, makers of automobiles and household white goods. Such producers of hardware tend to run high debt loads and are highly exposed to potential "disruptive technologies". For example, battery technology advances allow far more efficient storage of electricity, which will lead to the replacement of the combustion engine and with it the bankruptcy of a big chunk of our industrial systems.

In short, capitalism has rarely seen a time when both the forces of creation and destruction have been as powerful as right now.

The question is thus not whether we face inflation or deflation. For me, this one is settled in favor of deflation. As an investor, I need a portfolio that can handle both a deflationary bust and the benefits of a deflationary boom. Hence, I would tend to own shares in the automation category, hedged by US treasuries and dim sum bonds. This set-up should protect against a nasty outcome in both the energy sector and that part of the capital-intensive industrial complex that is especially prone to disruption.

Charles Gave is Founding Partner and Chairman of GaveKal Research. GaveKal is one of the world's leading independent providers of global investment research. It also advises several funds with combined assets of more than US$2bn. In Australia, GaveKal Capital's GaveKal Asian Opportunities Fund is available through Certitude Global Investments.