Seed Weekly

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seed investments

Are We Heading for Inflation or Deflation?

Over the last few weeks, we have highlighted the global debt bubble that appears to have now been pricked, not by the coronavirus itself, but the global lock down and the negative effect on economies.

Last week, I discussed the **Global Central Banks' Response** to the economic slowdown to try and avoid a recession. We explored just how quickly the major central banks, together with their respective governments, have tried to stabilise global markets.

Are Central Banks Putting Out Fire with Water or Gasoline?

Central banks essentially stand as lenders of last resort. They must try and maintain a low and stable level of inflation. This gets more and more difficult in an environment that, over multiple decades, has become increasingly unstable due to the high level of debt that they themselves have facilitated.

To give a sense of the increase over time, let's take a look at the US Central Bank, which has been the most aggressive –

- From 1980 to just prior to the 2008 global financial crisis, the US Federal Reserve steadily increased their balance sheet from around $200 billion to $800 billion.
- From 2008/2009 after three doses of quantitative easing, they pushed up their balance sheet to approximately $4.5 trillion.
- From an August 2019 low of around $3.7 trillion, it has now been expanded substantially to just shy of $6 trillion (and counting).

In the current global economic crisis, the US Federal Reserve Bank has announced *"aggressive action"* and will buy as much government debt as it deems necessary.

Surely All This New Money Creation Must Lead to Inflation?

Many investors pose the most obvious question, *"Surely a highly indebted global economy, with literally trillions in fresh new money being created, will lead to inflation*?". No, not necessarily.

Post the massive expansion of central bank balance sheets from the 2008/09 financial crisis, many investors anticipated inflation to pick up sharply. But, as far as consumer price inflation was concerned, it never really arrived.

This can partly be explained by the ever-decreasing velocity of money, which is defined as a country's gross output (GDP) to its money supply. There is very little inflation because the rate at which newly created money is being expanded is being offset by the lower and lower velocity of that money.

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If No Inflation Then, Where Did All the Money End Up?

Most of the debt created from central banks' expanding their balance sheets went into asset price inflation.

Cheaper and easier credit always makes it easier to buy both investment and non-productive assets. Those that had access to this credit pushed up an array of asset prices, including :

- Shares (direct and via share buybacks)
- Private equity
- House prices

There is a degree of circularity to this, because as asset prices are inflated, so they can sustain higher and higher debt levels – which in turn assists in pushing up prices again.

Until such time as a virus pricks the bubble.

Could We See Deflation?

Deflation – while quite a scary prospect for both governments and investors – is a possibility. Again, not necessarily consumer price deflation, but more likely global asset price deflation as debt levels need to be reduced in order to restore liquidity and reset solvency levels, where these are breached.

In this deleveraging environment, assets are sold down, and debt liquidated. This ideally occurs in an orderly fashion, but oftentimes disorderly, as we have seen in the last month.

This is why central bankers have now instituted **QE infinity**. They will now essentially try and do whatever it takes to reduce any fallout from deleveraging.

History indicates that they will probably go too far, but that is a discussion for another day.

Conclusion

Central bankers understand the huge negative consequences of asset price deflation, and so it is not surprising now that they are essentially saying that they will do whatever it takes to try and reflate the system.

As we have seen this will not only include zero interest rates and money expansion through the banking system, but also huge fiscal stimulus through direct government assistance to both businesses and the public.

All of this has consequences for our investments, which we will discuss next week.

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As always, and especially in these trying times, our team is available to answer any questions that you may have. Please feel welcome to phone us on +27 21 914 4966 or send an email to info@seedinvestments.co.za (general enquiries) or wealthadmin@seedinvestments.co.za (private client assistance).

Kind regards,

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