Seed Weekly

16 April 2020

Investing in an Inflationary or Deflationary World

To date investment markets have been playing out exactly as one could expect in a global economic shutdown. The massive liquidity panic in a highly leveraged system put immense strain on global credit markets, which has now led governments and their various central banks to do *'whatever it takes'* to try and hold the system together.

We discussed the enormity of what global central banks have only but started doing, and this week we also saw the SA Reserve Bank reduce its repo rate to 4.25% (the lowest level since introducing this system in 1998).

In light of this massive *"money printing"* - which typically leads to inflation - investors will need to consider which asset classes outperform. At the same time, investors need to consider how to position should the huge demand and supply shock lead to longer term deflation.

What are the types of Asset Classes?

In 1997, Robert Greer published a paper in the Journal of Portfolio Management, titled "*What is an Asset Class Anyway*?". Herein he classified three different types of investable asset classes, grouping those that had similar fundamental economic drivers.

<u>These 3 categories were labelled super classes of asset types :</u>

- Capital Assets
- Consumable or Transformable Assets
- Store of Value Assets

Capital Assets

He defined a capital asset as an ongoing source of something of value. This would include shares in a company, corporate or government bonds and rental producing fixed property, as they all have the main trait of providing a **stream of income** into the future for their owners. Ultimately these capital assets are, or represent, a claim on underlying assets and their stream of future income. For example, shares represent a claim as the ultimate owners of the business assets and its stream of dividend pay outs.

I would also include in this category all forms of bank deposits, from savings accounts to cheque accounts to fixed deposits. Ultimately, these are different forms of loans by an investor to a bank in return for an agreed rate of interest.

Capital assets are valued by discounting the future income stream. In an inflationary world, certain companies have a greater ability to adjust their pricing and costs and so provide some inflation hedge to investors. The fixed income stream from bonds and other similar investments provides no ability to adjust for inflation and so naturally they perform better in a world of deflation.

Real estate also typically does better in an inflationary environment, but because debt levels become increasingly burdensome in a deflationary world, more highly geared property investments will underperform.

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Consumable or Transformable Assets

The next super category he defined was that of consumable or transformable assets, which includes physical commodities such as grain, oil, platinum, copper, etc. He noted that with these assets, "*You can consume it. You can transform it into another asset. It has economic value. But it does not yield an ongoing stream of value.*"

Because these do not generate any income stream, the valuation methodology metrics used is focused on supply and demand and stock levels to annual flow levels. Naturally, the prices of these types of assets can be very volatile – the recent price movement of oil being an obvious example.

Commodities – or more often their derivatives such as futures and options – can be used as a portfolio diversifier in times of inflation. However, over the years technological advancements have resulted in the real price of commodities trending lower and lower. Where we have a global demand shock like we are experiencing now – this price pressure is exacerbated - making commodities a poor investment in a deflationary world.

Store of Value Assets

These are assets that, like commodities, do not generate an income into the future, but unlike commodities they are not typically consumed. They are sometimes also known as *"hard assets"*.

Some store of value assets may have aesthetic appeal, but from an investment perspective and in varying degrees of usefulness, they have some ability to store value into the future. Storing value ultimately means preserving the purchasing power of your savings against inflation.

Examples here range from one of the oldest and most successful stores of value – i.e. gold, to arguably one of the newest but not fully tried and tested – i.e. bitcoin – sometimes called gold 2.0.

Chart 1 : Gold Price Deflated by Inflation (1999 - 2020)

Source : Seed Investments (31 March 2020)

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Other possible “store of value” assets one would consider would include money (i.e. the notes themselves and not money in a bank which is actually a loan, and hence a capital good), collectible antiques, fine art, fine wines, rare coins, and even collectible watches and classic cars.

While conventional wisdom may say that gold and other store of value assets thrive in times of inflation, but wilt in times of deflation, depending on the asset itself, these should do well in both inflationary and deflationary environments.

Conclusion

The demand shock following the global shutdown, when seen in conjunction with the enormity of the global debt levels, leads us to think that global deflation may be around for a while. But because this can quickly morph into inflation, we believe that investors need to be positioned for both eventualities.

To summarise in a deflationary environment, you should avoid debt as it becomes more expensive in real terms. The bias should be towards store of wealth asset classes such as cash and gold, capital assets such as quality defensive shares and nominal bonds.

In an inflationary type environment, the type of investments that do well will include more leveraged companies, real estate, commodities, and inflation linked bonds.

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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