Creative Global Investments

Market Insights

Wednesday June 4, 2014

Steven Gluckstein
Global Strategist
sgluckstein@cg-inv.com
Tel: 732 768-8843

Creative Global Investments LLC
115 East 57th Street
11th Floor
New York, NY 10022
Tel: 212 939 7256

Creative Global Investments/Europe
5, op der Heed
L-1709 Senningerberg
Tel: (352) 2625 8640
Mob: (352) 691 106 969

Objectivity
Integrity
Creativity

The Perfect Storm: How Inflation Eventually Materializes

The debate over inflation has become increasingly polarized—perhaps due partially to the distortive impact of accommodative monetary policy by the world's leading central banks during the past five years. Hardly a day seems to go by when one doesn't read or hear a warning that a rapid escalation in inflation is imminent. Virtually any uptick in monthly data no matter how small is sufficient to unleash a cacophony of inflation alarms. Ironically, deflationary warnings have also been recently rising, primarily from the Eurozone, as many commentators will assure you that inflation is dead. Although, in our judgment, inflation will soon begin to creep higher, we see zero probability of it becoming a reincarnation of the Weimer Republic that many of the more virulent fear mongers suggest. Nor do we see it as a near term destructive force capable of derailing economic recovery. Nonetheless, when looking out over the distant horizon 24-30 months from now **we see several factors coalescing into a "perfect storm" that will likely propel inflation materially higher and cause significant challenges for central bank monetary policy three to five years from now. Rising budget deficits, resurgent wage growth and rising money velocity should all re-emerge as potent inflationary economic forces.**

The Federal budget deficit is forecast to begin growing again in 2016. The government's borrowing needs will rise just after the Fed has presumably begun to tighten sometime in 2015. In textbook fashion, borrowing rates would be pressured higher as the government begins to crowd out private borrowers. But what if the real world doesn't cooperate since it seldom operates in "textbook" fashion**? What if the Fed decides to maintain an element of financial repression by continuing to finance the budget deficit, which by its nature is inflationary given an economy presumed to be operating closer to full employment?**

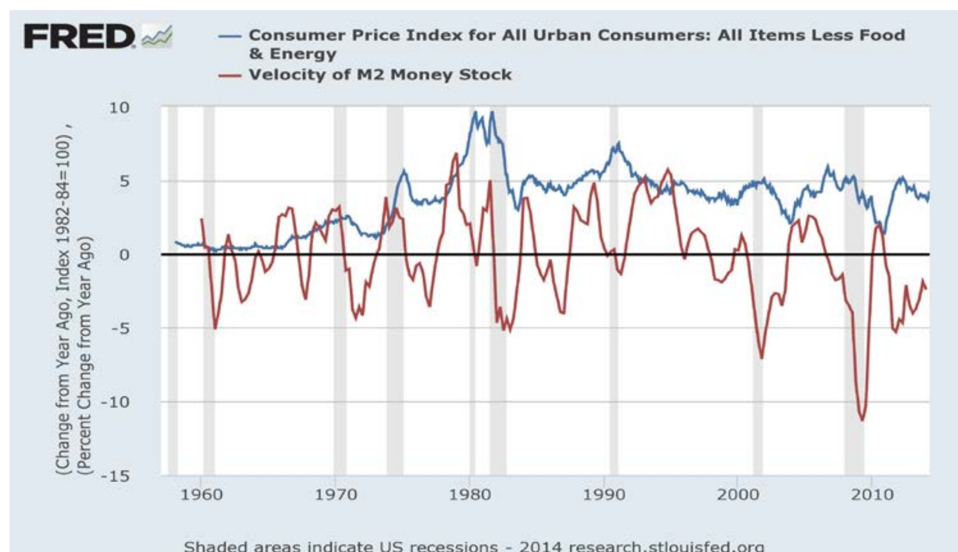
IMPORTANT DISCLAIMER: As a company purely focused on research, CGI LLC has no business relationships with the company covered in this report, be it investment banking, **consulting** or any other type of relationship. In addition, CGI LLC does not seek and does not intend to seek in the future any such businesses, maintains complete **independence** and has no conflicts of interest related to the companies in its research universe. Neither the analysts responsible for this report nor any related **household** members are officers, directors, or advisory board members of any covered company. No one at a covered company is on the Board of Directors of CGI LLC **or any of its affiliates.** In addition, CGI LLC and its employees, including the analyst who wrote this report, hold no equity, debt or other linked derivative investments, the value of which is related in **any** way, directly or indirectly, to the operating and stock price performance of the company covered in this report. No such investment positions are held in any of the **competitors**, suppliers or customers of the companies in our coverage universe. This report is provided for information purposes only. It should not be used or considered as an offer of securities and it does not represent a solicitation to either buy or **sell** any securities or derivatives thereof.

Seemingly overnight (and remember that 2016 is a presidential election year), pressure could build for the Fed to return to more accommodative monetary policy. Taken at face value two years hence this is unlikely to seem the sharp reversal in policy that many would believe it to be today. After all, the Fed is reluctant to begin raising interest rates and will be slow to enact such a policy shift. Fed speakers have been telegraphing this message with increased frequency in their public comments while ex-Chairman Bernanke has reportedly been very direct in his paid private meetings that interest rates will remain low for a very, very long time.

Given the dovish construct of the Federal Reserve Board of Governors, we suspect that the longer they delay raising rates, the greater the likelihood that they stay too long at the subdued real interest rate levels that help kick-start inflation. Historically, once the Fed begins raising interest rates, the pattern is one of steady frequent increases until the tipping point is reached when inflation starts to abate (along with the economy) as recession usually following in short order. Essentially, the Fed is forced to play catchup with market forces as they always wait too long. **The Yellen led Fed is unlikely to be different than the Greenspan or Bernanke led Fed that match the timeline in the graph below.**

When the Fed last faced such a choice, it was attempting to head off an overheating economy while unknowingly staring into the abyss of the Great Recession with the very real possibility of the collapse of the financial system. As the largess of the Fed subsequently played out at the discount window via its grand experiment with quantitative easing, the reluctance of banks to lend as asset prices were falling caused excess reserves to build up. Those same **banks were only too happy to recapitalize their balance sheets and earn risk-free returns by parking their excess reserves in interest-bearing deposits at the Fed rather than pursue risk-based lending to the private sector—essentially neutralizing the money multiplier effect.**

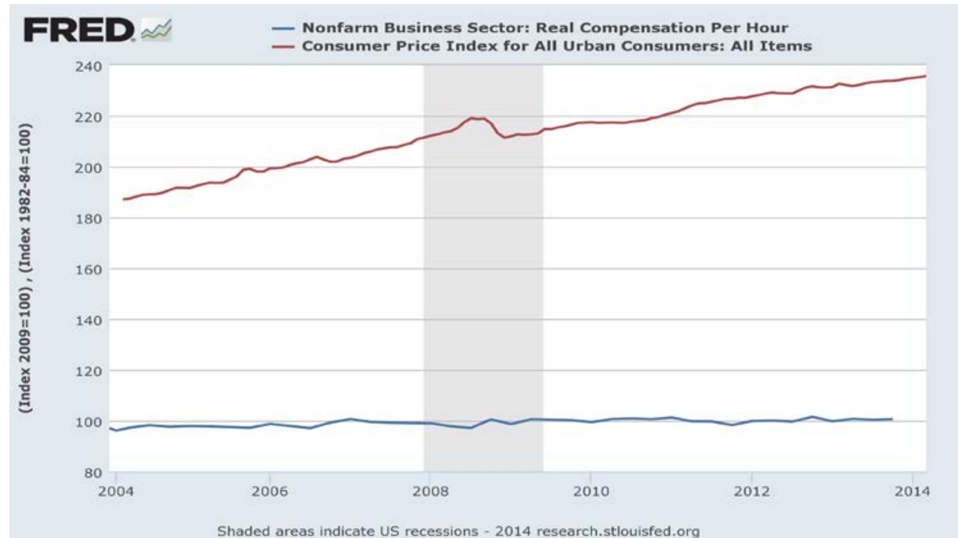
This is why inflation failed to materialize as the velocity of money fizzled. Even after emerging from recession, banks remained reluctant lenders as an unintended consequence of Fed policy. Only recently, have we begun to see lending standards ease coincident with a return in loan demand as the deleveraging of consumer balance sheets appears sufficient to accommodate assuming more debt. The graph on the following page clearly shows the unresolved conflict between GDP growth and the velocity of money. **Money supply must expand sharply to support sustained higher real GDP output. And as the second graph demonstrates, when money supply expands, inflation always follows.**



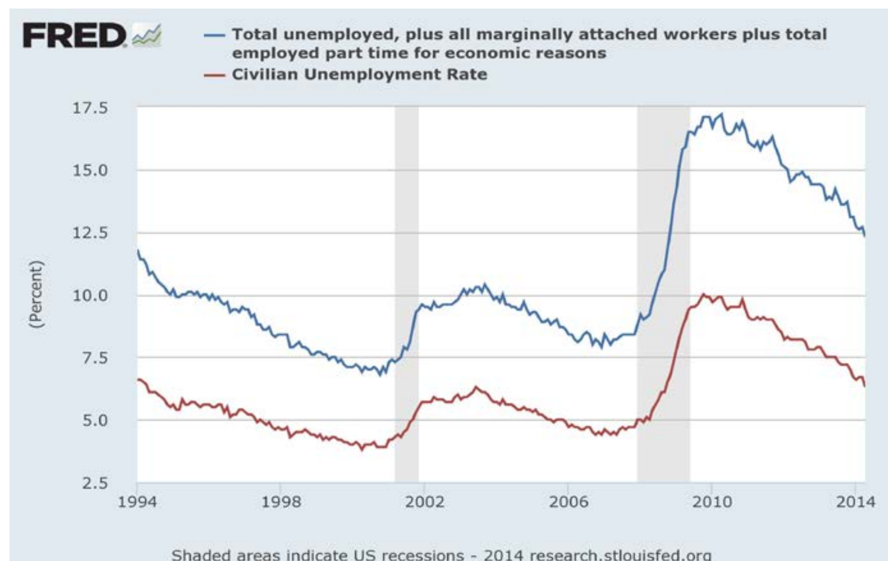
The Fed realizes this just as other central banks around the world do. That is why the European Central Bank is forecast to cut interest rates to 0.10% from 0.25% tomorrow. **More importantly, the ECB is considering setting negative interest rates on bank reserve deposits held by it to encourage an increase in private sector lending by banks to stimulate the economy and generate inflation. Should the ECB enact such a change in reserve policy, rest assured that no other institution will be looking on with more interest than the Federal Reserve.**

This how political pressure will be exerted in Washington when the cry for renewed stimulus returns since many voters believe that the banks essentially got a free pass without having to "give back" to the economy. It's a perception problem that continues to linger. Even as the economy slips into another economic downturn, in our view, it would be foolhardy to believe that the Fed would follow an identical policy initiative to the past five years to protect the banks, even those "too big to fail" without ensuring that not only Wall Street but Main Street sees the benefit of the Fed's money creation. Action by the ECB aimed at encouraging bank lending could place additional pressure on the Fed**. Washington politicians, facing a tough upcoming election, would no doubt relish the opportunity to redirect attention away from our dysfunctional Congress toward Fed policy as the source of stymied economic growth if European lending picks up on the heels of a change in policy by the ECB that contradicts the Fed's own favorable treatment of member bank reserves.**

The third member of our triumvirate of inflation catalysts is wages. Real wage growth has been nonexistent for the past decade, failing to keep pace with consumer prices as the relative US standard of living has come under assault. Cost-push inflation? Not a concern. Even Milton Friedman would have had a hard time making a case for it from the following graph. So what do we see that others are overlooking?



As the unemployment rate falls, employment slack is reduced. Although the often cited broadly defined U6 unemployment rate (top blue line in the graph below) remains elevated, we note that it didn't diverge from its historical ratio to the more narrowly defined unemployment rate until late in the last recession—coincident with the arrival of the first baby boomers at retirement age. Ample anecdotal evidence exists that shortages of certain skills have become more pronounced. Bidding wars are beginning to break out among companies for those skilled workers in short supply and they will become more commonplace. The movement for higher minimum wages also continues to gain support. Recent passage by Seattle of a scaled increase to a $15/hr. minimum wage is not an isolated event in our view. **Wage growth accelerates as labor plays catch up [surprisingly quickly] for years of stagnant/negative real wage growth. Perhaps just as importantly, and as we've written previously, nascent business investment leads to new hiring.**



Finally, as tertiary factors: home prices continue to recover; credit (as we mentioned earlier) is becoming less restrictive and labor mobility is rising—all acting as an impetus for higher consumer spending. **All coalesce to create a perfect storm of rising inflation in 2016.**

We have some specific thoughts for portfolio additions as inflation starts to heat up. While we view these selections as inflation hedges, one could rightly consider them appropriate mid-to-late economic cycle plays regardless of one's view on inflation. Accordingly, these stocks should be considered for long-term core holdings that could be accumulated now.

- Energy—oil has offered superior protection to many other commodities, including gold, when inflation rises modestly in the two to four percent range. While one can always purchase crude futures for direct exposure, we believe better returns can be gained through exposure to the large integrated oil and gas producers that are currently trading at historically attractive valuations. Energy is currently one of our favorite sectors and over weighted in The CGI Global Fifty recommended list, which includes the following seven stocks:

    - Chesapeake Energy (CHK)
    - Gazprom ADR (OGZPY)
    - Petrobras ADR (PBR)
    - Range Resources (RRC)
    - Repsol (REP:MSE)
    - Statoil ADR (STO)
    - Total ADR (TOT)

- REITs—our sector preference is for office, commercial and multi-family residential in that order.

    - Mitsubishi Estate (8802: JP) is on the CGI Global Fifty list. It is structured as a corporation with commercial and residential real estate holdings primarily in central Tokyo. The shares are currently valued at 2.6x book.
    - Boston Properties (BXP) REIT focused on office properties
    - Duke Realty Corp. (DRE) Commercial real estate REIT
    - Equity Residential (EQR) Multi-family residential focused REIT
    - Vanguard REIT ETF (VNQ) This large cap ETF provides exposure to those sectors we like while for the most part avoiding sectors such as mortgage REITs likely to present bigger challenges in a rising rate environment.

- Agricultural commodities—the continued rise of the emerging middle class in populous emerging nations such as China, India and Indonesia is producing demand that will outpace supply as arable land shrinks (even after factoring in rising agricultural productivity) and protein consumption rises. Direct exposure is most efficiently obtained via futures contracts. Although many exchange-traded funds exist, most are impaired in one way or another by structure (K-1 partnership) or poor liquidity.
    - Bunge (BG) is on the Global Fifty list and has three main global businesses: agribusiness, food products and fertilizer.

Carlo R Besenius, CEO & Head of Global Strategy
cbesenius@cg-inv.com
office: +(352) 26 25 86 40
mobile: +(352) 691 106 969
Luxembourg/Europe

Steve Gluckstein, Global Strategist
sgluckstein@cg-inv.com
office: 212 939 7256
mobile: 732 768 8843
New York, NY, USA

Sabine CJ Blümel, Head of Global Automotive Research
sblumel@cg-inv.com
office: +44 (7785) 301588
London, UK

Marc Peters, Head of Global Industrial Strategy
mpeters@cg-inv.com
office: +(352) 26 25 86 40
mobile: +352 621 36 44 50
Luxembourg/Europe

Trish Twining, Managing Director of Sales
ttwining@cg-inv.com
office: 781-771-0117
Boston, MA, USA

Allison M Cimon, Director of Sales & Technology
amcimon@cg-inv.com
office: 646 228 4321
Boston, MA, USA

Gary Schieneman, Managing Director,
Global Accounting and Finance
gschieneman@cg-inv.com
office: 917-868-6842
New York, NY, USA

Jennifer Crisman, COO
jcrisman@cg-inv.com
office: +(352) 26 25 86 40
Luxembourg/Europe

IMPORTANT DISCLAIMER: As a company purely focused on research, CGI LLC has no business relationships with the company covered in this report, be it investment banking, **consulting** or any other type of relationship. In addition, CGI LLC does not seek and does not intend to seek in the future any such businesses, maintains complete **independence** and has no conflicts of interest related to the companies in its research universe. Neither the analysts responsible for this report nor any related **household** members are officers, directors, or advisory board members of any covered company. No one at a covered company is on the Board of Directors of CGI LLC **or any of its affiliates.** In addition, CGI LLC and its employees, including the analyst who wrote this report, hold no equity, debt or other linked derivative investments, the value of which is related in **any** way, directly or indirectly, to the operating and stock price performance of the company covered in this report. No such investment positions are held in any of the **competitors**, suppliers or customers of the companies in our coverage universe. This report is provided for information purposes only. It should not be used or considered as an offer of securities and it does not represent a solicitation to either buy or **sell** any securities or derivatives thereof.