

Thought for the Week: Tuesday, January 31st, 2011

Stagflation and the Need for Inflation Protection

Let's start with the **Wikipedia definition of Stagflation**:

...the situation when both the inflation rate and the unemployment rate are persistently high. It is a difficult economic condition for a country, because when inflation and economic stagnation are occurring simultaneously, a policy dilemma results since actions that are meant to assist with fighting inflation might worsen economic stagnation and vice versa.

Sound familiar?

Stagflation is usually stagnant economic growth coinciding with high inflation; the definition above uses high unemployment as a proxy for stagnant growth.

Although the U.S. and global economies seem to be growing rather well at the moment, therefore stagnant growth is not in the immediate outlook even though inflation and high unemployment may be with us for the foreseeable future.

It can certainly be argued that **high unemployment may not lead to stagnant growth in this particular economic cycle** as emerging markets and increased productivity can take up the slack. But are we in the clear with respect to Stagflation: Yes or No?

For risk-adverse asset managers such as ourselves, **persistent unemployment and inflation are like an unstable chemical**. If handled correctly, they are fine - If they get shook up, anything can happen. Just like Nitroglycerin, jobs and the cost of living need handling with care or rapid Stagflation could occur.

Stagflation has generally proven to be very difficult and, in human terms as well as budget deficits, **very costly** to eradicate once it starts

Which brings us to the U.S. economy and Egypt...

A little U.S. History

The last time the world experienced Stagflation was in the mid- to late-1970s. It is generally accepted that this was caused by two factors. One was a series of **"adverse supply shocks"**, mainly the huge run up in the price of oil. The other was **excessively expansionary monetary policy**, especially in 1972-3, allowing to become entrenched in our economy.

Sound familiar?



But the world is recovering from recession so surely everything should work out fine? **There's enough growth to go around, isn't there?**

We are not saying Stagflation will happen; we look for potential threats to our portfolios and positioning to protect against these threats, should they occur.

U.S. Economic Outlook

Stagflation can result when the productive capacity of an economy is reduced by **an unfavorable supply shock, such as an increase in the price of oil** for an oil importing country. Such an unfavorable supply shock tends to raise prices at the same time that it slows the economy by making production more costly and less profitable.

Secondly, **both stagnation and inflation can result from inappropriate macroeconomic policies.** For example, central banks can cause inflation by permitting excessive growth of the money supply.

Know any Oil Importing Countries? Know a country rapidly expanding their money supply?

Egypt

Last week the market was spooked by rioting in **Egypt, a country with high unemployment and high inflation.** Should we change the PIIGS to the PIGIES?

For all practical socio-economic thinkers, this type of social unrest and political dissatisfaction should be a fait accompli for countries with budget deficits, who are cutting wages and services at the same time as prices are rising. For those of us who grew up in the 1960s and '70s, it's surprising there aren't more demonstrations.

The main reason Egypt spooked the markets wasn't its economic position, it was its geographical location. **More specifically; its proximity to oil supplies** and its control over Suez Canal traffic.

The world and U.S. economies are unstable elements, like nitroglycerine, they respond badly to sudden shocks. **An 'unfavorable supply shock', like the sudden increase in the price of oil can cause an economic explosion,** as previously described.

Slowing growth with rising inflation would be explosive! It's a difficult scenario for Central Bankers to deal with for if they raise rates they kill growth and suppress employment. However, if they do not keep rates low, Inflation inevitable increases and speculative growth can get out of control.

And we are seeing **plenty of evidence of pent-up price increases in commodity demand and producer prices.** We expect the official rates of Consumer Price Index increases to mirror the increased food and energy prices most of us are already paying for in our daily lives.

So, How might Investors Protect Against Inflation

Whenever one asset class or economic indicator falls, another tends to go up by a similar amount. A simple axiom but generally true.

Investors looking to protect themselves from the negatives of inflation, and possibly benefit from the positives, should focus on three main areas:

- 1. Commodities:** In the six previous examples of Stagflation, commodities produced positive returns; outperforming stocks and only failing to outperform Bonds in one of the six periods. The expansion of emerging markets may not be good for every developed-country consumer, but it should generate continued demand for a wide range of commodities.
- 2. Equities, especially income-paying securities:** Stagflation normally causes equities to fall in price; however, buoyant growth in emerging markets, continued technology and productivity advances, combined with an absence of spiraling wage claims, suggest this time may be different. Moreover, well-run companies with pricing power and defensive, dividend-paying companies traditionally benefit from Stagflation. Companies that are able to pass on raw material cost increases include strong global brands in consumer, materials, telecoms and energy related sectors.
- 3. Floating and Inflation-linked Debt:** Stands to reason this type of security will become more valuable as inflation and interest rates rise. Why not participate?
- 4. Interest Rate Hedges:** Inflation and Interest Rates are generally synonymous. There are a number of securities that appreciate when interest rates rise, including TBTs and PSTs.

The DIAS Inflation Protection Portfolio invests in the above areas and seeks to hedge against rising Inflation and Stagflation. As a DIAS Explore Portfolio it is used by investors to hedge the risk of these economic trends.

As an Explore portfolio, it may be more concentrated and volatile than conservative Core portfolios and should not be used for a majority of an investor's assets.