PERENNIAL ASSET MANAGEMENT

Perennial Perspectives

Beware What Is Lurking

Halloween is here and monsters are again forcing us to look over our shoulders. The disinflationary period we have been living in had central bankers fearful of outright deflation. However, is it the inflation goblin that is sneaking-up on us?

As students of history, those bankers studied the deflationary effects during the depression and are stimulating our economies to avoid another period of chaos similar to what occurred after the 1929 stock market crash. The last seven years of fear brought numerous Quantitative Easing (QE) programs, one Operation Twist, six years of near zero interest rates and very large fiscal deficits to stimulate the U.S. economy. Not to be left out, Japan jumped on Abenomics and in a few years the Japanese central bank has purchased the majority of Japanese government bonds in existence and recorded large fiscal deficits. The Euro countries eventually caught on and are now spending more than a trillion Euros on their Asset Purchase Program under a President Draghi of the European Central Bank who committed to do "whatever it takes". This period of unprecedented stimulus brings us to today.

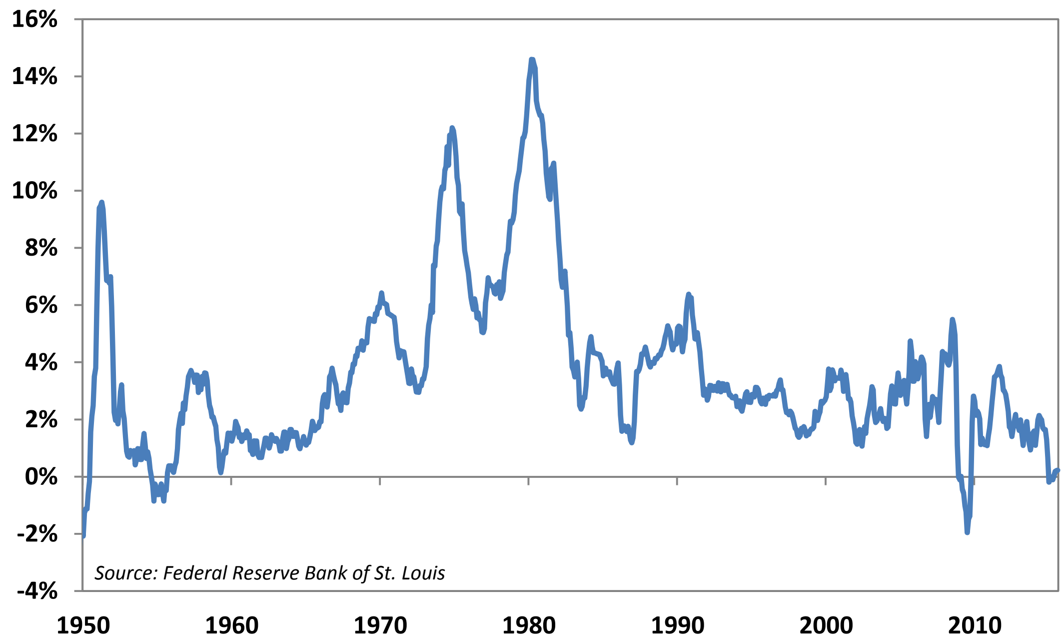
Many economists have been predicting an increase of inflation ever since the first QE program in 2008, but the inflation monster remained subdued. Since then investors have learned that inflation was not something to be concerned about and have operated comfortably in a disinflationary environment. Now the Fed is starting to worry about inflation and have warned investors that interest rates will start rising soon. The headline inflation numbers are still under control but a closer look is in order.

At Perennial we have concluded that portfolios need to be repositioned for this changing world. Longer term bonds may suffer as interest rates are inadequate to compensate investors for higher inflation, while equity investors need to be positioned in companies that will benefit from increasing inflation.

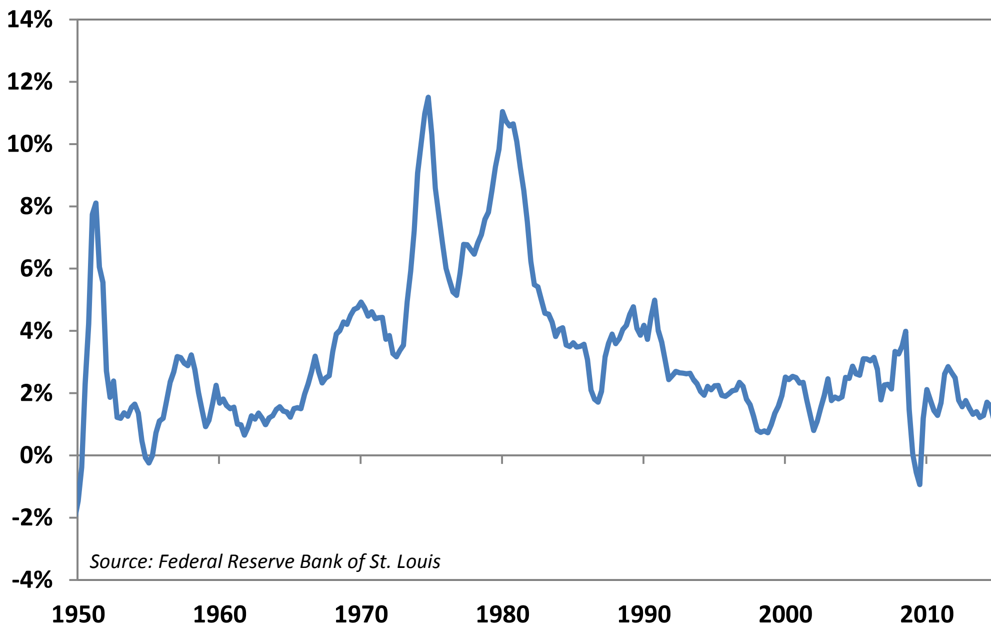
Looking for Inflation

The U.S. Federal Reserve's (the Fed's) every word is being scrutinized to gain insight into when they will raise interest rates. While the world is watching the Fed, history tells us that the key item to watch is inflation. Since 2008, despite the Fed's aggressive stimulus programs, the United States has been in a disinflationary environment. Today, there are signs that inflation is picking up, but you need to dig to find these signs.

For example, looking solely at U.S. CPI (Chart 1), one would be hard pressed to conclude that inflation is a problem.



The Fed watches two key metrics among the many things they review - inflation and real growth. The Fed's preferred inflation gauge is the personal consumption expenditures (PCE) deflator and for real growth they prefer unemployment as their proxy. As Chart 2 shows, it is no wonder why the Fed is reluctant to stop stimulating as the PCE is just starting to improve from a historically low level. We would be hard pressed to find any evidence of inflation here.



Total U.S. nonfarm payrolls rose by more than 12 million from January 2010 to September 2015. Unemployment has been falling, as is depicted in Chart 3, because of these new jobs and unemployment is reaching a level where pressure on compensation normally increases. Currently, when we search to find evidence of compensation pressures, results remain inconclusive. Hours worked isn't improving, overtime hours are weak, and the employment cost index is not increasing strongly. Anecdotally we are seeing Wal-Mart, McDonald's and Target raising minimum wage levels, which indicates that they are having turnover problems.

The low unemployment number is what has the Fed uneasy and thinking they should begin raising rates. Even with all these newly employed workers, it is difficult to see any signs of inflation in either the CPI, the PCE or in rising wage pressures.

However, as we look at Chart 4, it becomes evident that the U.S. CPI Services index is increasing. As services are at the desired inflation level, commodities on average have fallen close to 50% since reaching their peak in 2011. The magnitude of the commodity decline and the increase in value of the U.S. dollar has meaningfully reduced prices while other costs have risen. If one assumes that commodities have hit their low points and the U.S. dollar will not continue to strengthen, inflation numbers should reflect the increasing cost levels that are already present.

Chart 3: U.S. Unemployment Rate

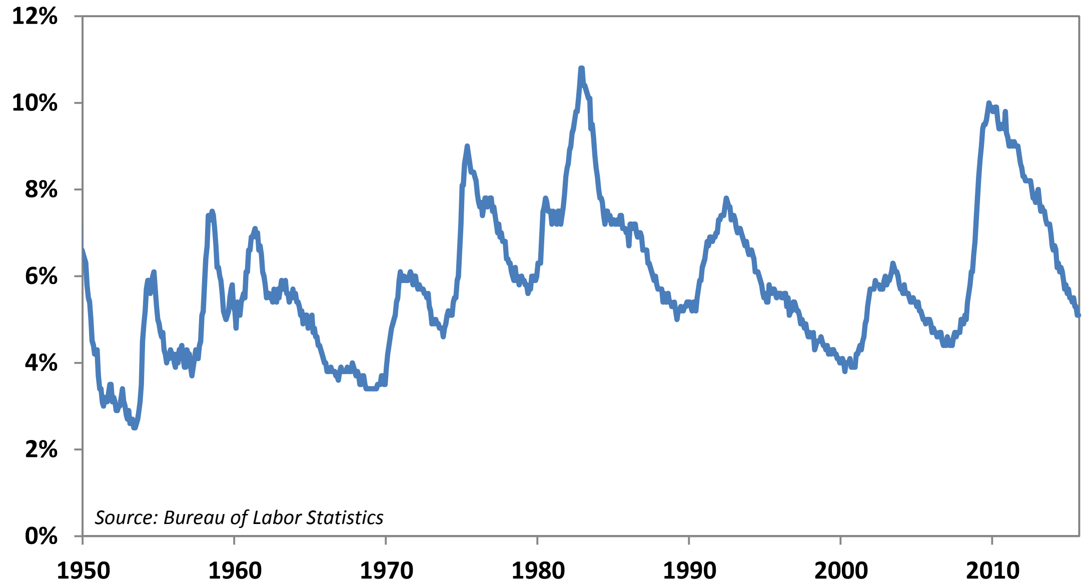
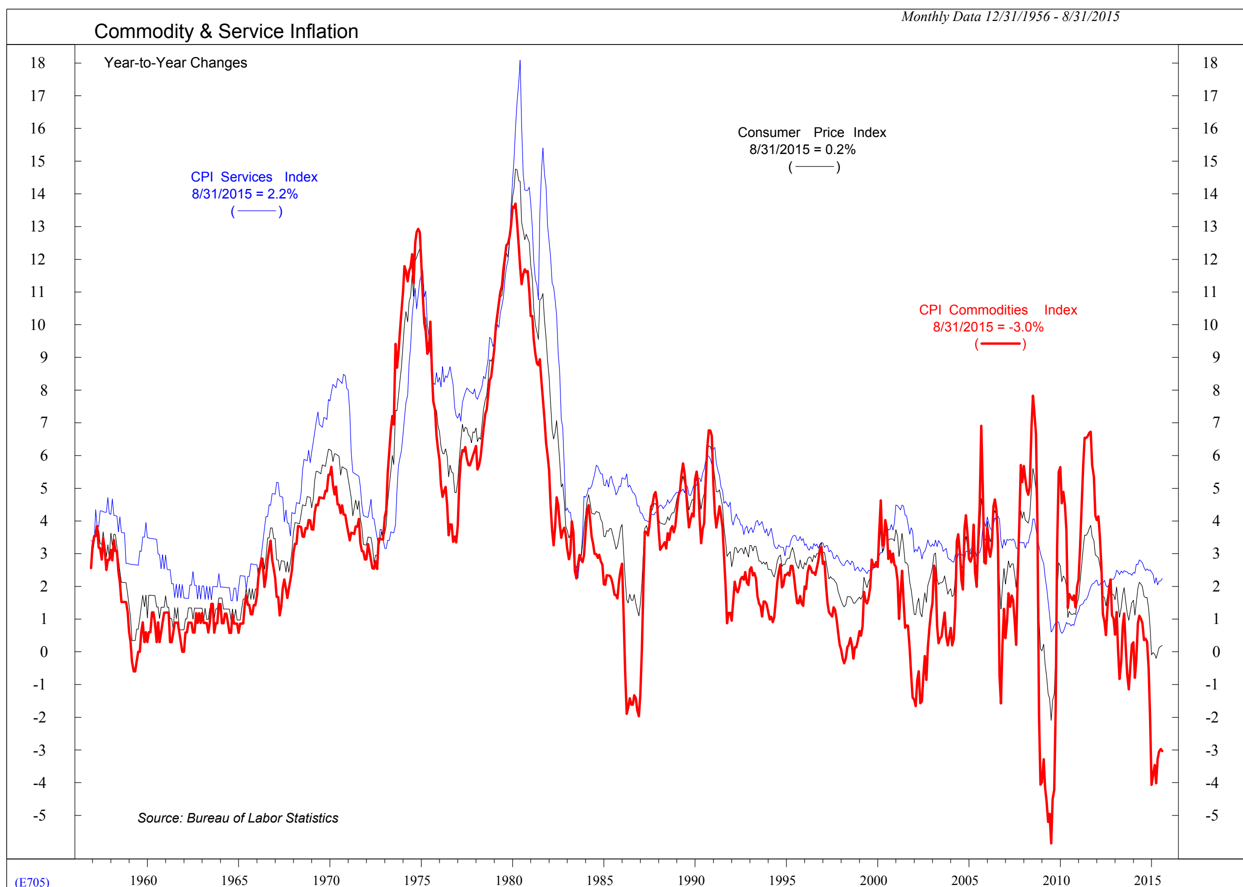


Chart 4: Commodities & U.S. CPI Services Index



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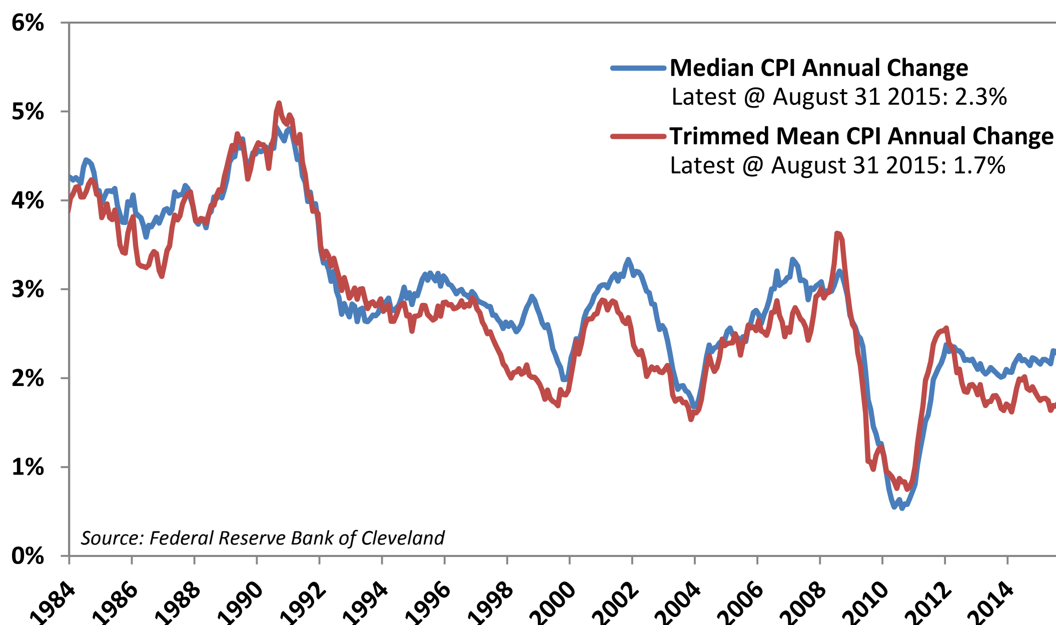
Finally, as is evident in Chart 5, the median and trimmed mean U.S. CPI both show inflation on average is bubbling along near the Fed's desired 2% level. Both of these measures are starting to gain favour among some Fed governors, as these statistics remove the outliers and show what is happening to consumer prices.



Given that inflation is not evident in the broad U.S. measures and that there appear to be many problems in numerous global economies, the Fed is reluctant to tighten monetary policy, even by a quarter of a percent. This is typical of what happens at this late stage of an economic cycle, as Fed governors do not want to be responsible for putting on the brakes after stimulating so hard to get the economy going. Hence, economists worry that the Fed is "behind the curve" and will tighten too late.

At Perennial we see modest inflation bubbling below the surface and we expect interest rates and inflation expectations will begin to reflect this changing environment. This conclusion will have a significant impact on the positioning of both our equity and fixed income portfolios.

Perennial has made a tactical change to its portfolio positioning.

Performance in both Perennial portfolios has been excellent so far in 2015, because each portfolio has been positioned for the disinflationary environment.

As noted above, we are now expecting inflation to begin to emerge from recent low levels and we repositioned our portfolios in late September. We expect this different environment will put substantial pressure on the bond market, as investors remain positioned for disinflation. At this juncture, we believe commodity prices will stabilize and likely even bounce from their current low levels. If this occurs as we expect, it will have a substantial impact on both the bond and stock markets. We are therefore changing the Perennial portfolios to protect the sizeable gains we earned in 2015 in both portfolios.

If you are interested in knowing more about our current view, please contact me - my coordinates are below.

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