Inflation:

Looking beyond the Twilight Zone

August 2020

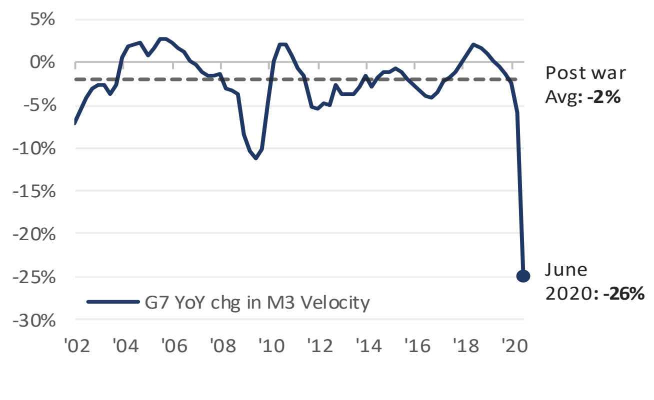
"Belief is a wise wager. Granted that faith cannot be proved, what harm will come to you if you gamble on its truth and it proves false?" Blaise Pascal

The quantity of money in circulation – the summation of every bank account, current and savings, corporate and personal – has grown at well over 30% since March, the fastest rate since 1528[1]. This is a staggering number, comfortably eclipsing the monetary experiments of the 70s that led to 15% inflation and - according to BoE data - even the attempts to print our way out of war time debts in the 1700s.

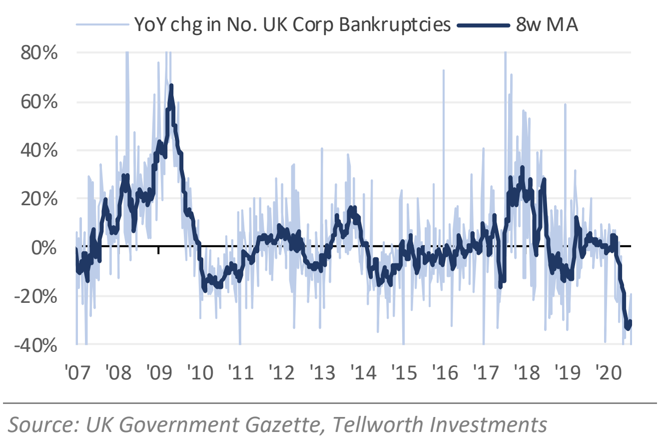
Fit for the biggest shock to growth in living memory, the big monetary experiment has created some extreme conditions in the economy and markets. In this 'Twilight Zone', where UK Q2 GDP fell 22% but the number of corporate bankruptcies actually *fell* – again at an 'unprecedented' rate – even uncertainty itself is at a record: three out of every five companies have abandoned guidance, there is a record spread of sell-side forecasts, both macro and micro, and the various 'policy uncertainty' are multiples higher than any time before. The mystery most pertinently extends to the one thing which is intuitively linked with the supply of money - the exchange rate between money and goods. Inflation.

We know that the cratering velocity of money – the amount of times one £10 note changes hands, or GDP divided by the quantity of money – is behind the surge in asset prices. Excess liquidity, and there is a lot of that right now, has been saved*, benefitting the highest quality assets first. Bonds, credit and quality growth stocks. The FTSE All-Share has underperformed the S&P by 24% over the past 6 months – the most since a very dark stretch in 1975, with severe political and social tensions and the doubling of interest rates[2]. This is unlikely related to renewed hard-Brexit risks, the crescendo of which normally helps the FTSE 100. It more likely echoes the current sizable deflationary forces, lower global yields and the bifurcation between tech and old economy – with the UK equity market very weighted to the latter.

The Twilight Zone – Money velocity has cratered... But, oddly, so have corporate bankruptcies



Source: Bloomberg. NB: G7 is the 'group of 7 countries' and Money Velocity is measured as Nom GDP / chg. M3



Source: UK Government Gazette, Tellworth Investments

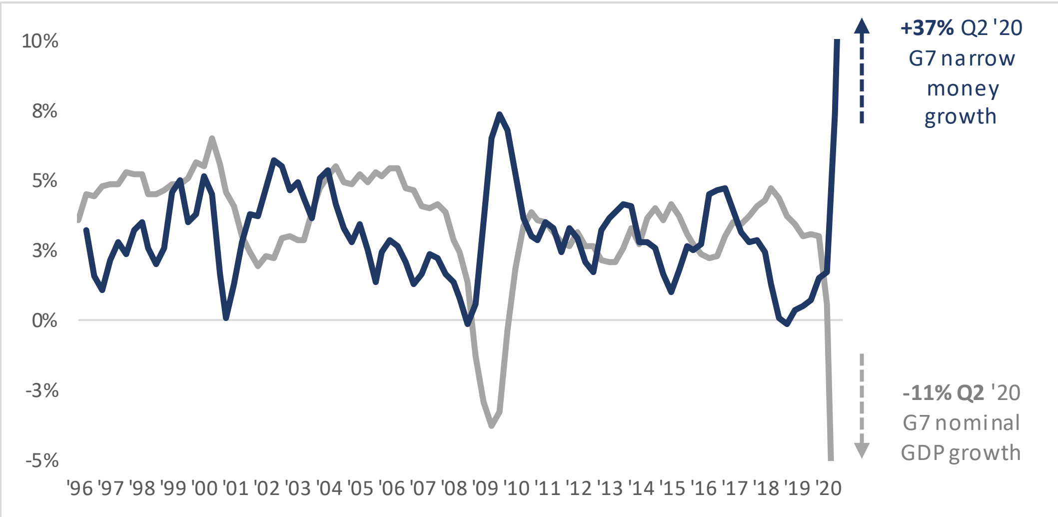
[1] Source: https://ftalphaville.ft.com/2020/07/06/1594059505000/If-you-follow-the-money--where-does-it-lead-/
[2] Source: https://www.weforum.org/agenda/2015/06/why-are-the-uks-long-term-yields-so-low/
**We use 'saved' as shorthand here (as all money at any time is technically saved). What we mean is that there is more long-term 'saving' vs. short-term liquid cash for consumption*

With this huge dispersion of assets, the path of this 'velocity' from here is crucial, although clearly unknowable, but we can start to think about how the economy might look if - like most things - it begins to normalise.

The relationship between money growth and *nominal* GDP is an established one by monetarists and indeed quite convincing to anyone who pulls up a chart of the two series – particularly if you can extend the series to the full post-War period as many do (see monetarist Simon Ward's blog). It is mostly driven by the inflation component – although there can be a short impetus to real demand. Importantly, what becomes clear quite quickly is that there has been a reasonably consistent circa 18-month lag between money supply expansion and a nominal GDP response.

Now, the literally off-the-charts money growth has broken this simple model – it forecasts well-over 10% nominal growth for the G7 in 2021. It is very likely that velocity has at least partly permanently fallen, that the desire to hold permanently higher cash as a proportion of income - a margin of safety - has risen. But when set against the sheer scale of money growth, the historical context (such growth has never *not* preceded a step change in inflation) and the so far encouraging global path of recovery, it seems unwise not to at least consider the potential for large inflationary surprises over the next year.

Broken historical relationship between lagged narrow money growth and *nominal* GDP?



Source: Bloomberg. NB: G7 is the 'group of 7 countries' and Narrow Money is M1/M2 depending on the economy

What could go wrong? We mentioned above that velocity could remain rooted to the floor, perhaps driven by new waves of cases and winter lockdowns. Another big risk is that the money supply snaps back, that government and banks lose either the willingness or ability to create money (to lend). This seems unlikely to us – there is broad commitment to the experiment, which has already seen a much faster recovery in consumer spending than many observers, including us, might have thought. The taps are likely to be on full blast for several months still. In fact, the main risk is voluntary private deleveraging – paying back, rather than spending Covid loans – an entirely reasonably and prudent response to an economic shock but one that further damages the patient. The actions of the state are important here – demand must continue to be supported despite optically ballooning deficits.

For us, the most interesting part, is how assets are priced in the context of the above. I've definitely already used enough superlatives for a year's worth of Bugles – but as we've seen, long term rates are very very low and old economy cycle stocks very very cheap. 'Deflation on steroids', as a colleague put it, is the game and one that you have not been able to beat for decades.

We do not know what will happen. But we do know, from the above and from history, that there is probably a very broad range of inflation outcomes, with a lot of positive skew (small chance of high values). So, when we think about portfolio construction for the next 12 months, we need to factor the potential for extremes, for things to look very different to today.

We have begun the tradition of shoehorning philosophical quotes into the Bugle and you have probably connected the dots already – the risk/reward profile on inflation looks a little bit like a Pascal's Wager. Protection is quite cheap, and the stakes are very high.

Seb Jory co-manages our TM Tellworth UK Select Fund, a large cap UK absolute return UCITS strategy that has delivered +10.42 % YTD (vs the FTSE All Share -21.78%) Returns quoted are net of fees on the F share class as of 31/07/2020. Source: FE Analytics, Bloomberg.

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