Inflation
An Australian Equity Perspective

We are at a confluence of deflationary and inflationary forces. The deflationary forces of debt overhang and demography are considerable. Yet, against that, we are in the midst of perhaps one of the greatest peacetime expansionary monetary policy experiments in history. In this environment, we can make no predictions about the timing of a return to inflation.

Yet, we believe equity investors should consider inflation risk within an asset allocation framework. In this Investment Research, the Lazard Australian Equity team looks at inflation and its implications for portfolio construction.

Our view is that inflation is a more likely outcome than deflation over the long term. Equities can serve as a hedge against inflation, but investors should be very selective in terms of stock selection. The biggest risk appears to be in banks and domestic cyclical companies, while the biggest beneficiaries of inflation would be global exporters.

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What We Thought We Knew in 1990

In 1990, most equity investors and economists could have been forgiven for thinking they understood inflation reasonably well. The work of Milton Friedman and Anna Jacobson Schwartz in *"A Monetary History of the United States"* had reached the famous conclusion that *"Inflation is always and everywhere a monetary phenomenon"*.[1]

This so-called "quantity theory of inflation"—which posited that increasing the money supply could push up prices—appeared triumphant and seemed to conform to past episodes of high inflation (e.g., pre-revolutionary France, the United States during the Civil War, post-World War I Weimar Republic). The Bundesbank's relative success with monetarist policies lent further credibility to this theory. Federal Reserve Chair Paul Volcker's success in reducing inflation through tight monetary policy in the United States over the 1980s appeared to confirm that we understood inflation.

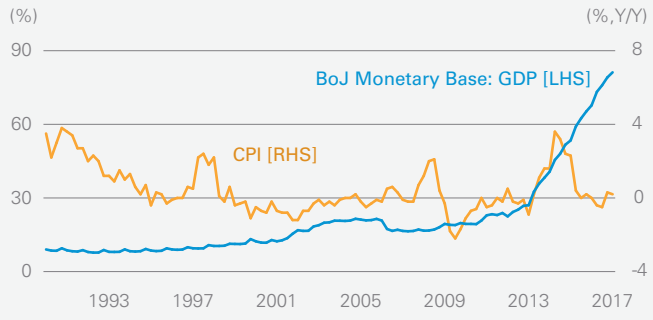
Japan

Yet, the experience of Japan over the last 25 years has gone against this orthodoxy. Despite expansionary monetary policy, including negative rates, a nine-fold increase in the monetary bases relative to GDP, and rapid rises in government debt, inflation has remained subdued (Exhibit 1).

In fact, Japan has struggled through lengthy periods of **deflation** over that period. Despite extraordinary monetary policy and the temporary impact of tax changes in the Consumer Price Index (CPI), inflation has averaged less than half a percent since 1990. In light of this market evidence, perhaps we did not understand inflation as well as we thought.

The example of Japan appears very relevant to the developed world today. While Japan could have been dismissed as an outlier in 2007, the United States, the European Union (EU), and the United Kingdom have all followed similar policies since the global financial crisis. None has experienced a significant increase in inflation.

Exhibit 1
Monetary Supply Has Exploded, but Inflation Has Remained Quiet



As at May 2017
Source: Lazard, Bank of Japan, UBS

Although we may not know exactly why this is so, it can be nevertheless instructive to examine some of the theories and their potential implications for Australia.

Demography: One explanation for "secular stagnation" and low inflation is demographics, and the ageing of the population is certainly a dynamic in which Japan has led the world. If this is a source for disinflationary pressures, then we should expect inflation across the G7 nations and eastern Asia to remain low. Europe, China, Taiwan, and Korea are all following the demographic trends of Japan. Although we expect that the effect will be less severe in Australia, it is not immune to this dynamic.

Debt levels: The overhang of the global financial crisis and extreme private and public debt levels in much of the Western world is another explanation for low inflation. Given Australia's historically high debt load, this is perhaps the most concerning reason from an Australian investor's perspective.

This rationale suggests that Japan experienced a balance sheet recession in the early 1990s and, ever since, households and corporations have been de-levering. Additional income is thus used to repay debt and acts as a powerful drag on growth and inflation.

It can be useful to examine how Japan got into this debt trap. In the first half of the 1980s, the Bank of Japan (BoJ) committed, in retrospect, a policy error. Partly in order to bring down the exchange rate, the BoJ lowered rates from 5.0%–6.0% to 2.5%. Interest rates remained at that level for an extended period due to the 1987 stock market crash (which, in turn, led to a global easing of monetary policy). Historically low interest rates drove a debt-fuelled property boom, which ended in a collapse in asset values and the subsequent deflationary environment.

This cycle has since repeated in other countries.

In the early 2000s, the introduction of the euro in EU periphery countries (such as Greece, Spain, Portugal, and Ireland) brought their interest rates down to the levels more typical of EU core countries. These low interest rates led to a debt-fuelled property boom, which again, ended in crisis that is still not fully resolved.

In the United States, Fed Chair Alan Greenspan cut rates to a low of 1% after the NASDAQ crash in the early years of the 2000s. Again in our view, in retrospect, this was also a policy error. The NASDAQ crash was mostly an equity phenomenon, not one based on debt and the low rates ignited a debt-fuelled property bubble that ended badly in the global financial crisis.

Post the financial crisis, the Anglo-periphery countries (Australia, New Zealand, and Canada), which had had a "good global financial crisis" and were not de-leveraging, inherited very low rates from the core US/EU, which in the future may well also be identified as a policy error. Inappropriately low rates led to a debt-fuelled property boom, but these have not yet unwound.

These credit cycles are illustrated through the private nonfinancial debt to GDP ratio of Japan, United States, Spain, and Australia (Exhibit 2).

The Social Explanation

This leads us to several questions: Why did "inappropriately" low rates lead to inflation in the 1970s, but to asset price bubbles since the 1990s? Was there something different about the economic structure?

One possible explanation for the different behaviour of inflation in the 1970s and the 2000s is the long-term social/political cycle. Exhibit 3 shows income inequality (measured through the share of income received by the top 1%).

Prior to 1929, capitalism was global and relatively unrestrained and as a result, inequality was high—it seemed at times that investment bankers, most notably J Pierpont Morgan, were more powerful than the US president. This dynamic all changed after the Wall Street crash of 1929 and the Great Depression, which led to the "New Deal" and later the "Great Society" program.

Income tax rates rose sharply, unions gained power, and inequality declined. Wall Street's influence declined until 1974, when the stock market again crashed, this time due to rising inflation and low growth. This crisis led to the Reagan/Thatcher supply-side/monetarist revolution, as the pendulum swung back towards capital and away from labour. By 2008, the United States once more had high inequality and powerful Wall Street banks.

From an income distribution perspective, Australia is a more equal society but, regardless, has followed those cycles with a lag.

If the global financial crisis of 2008 does turn out to be another societal turning point, which rolls back globalisation and increases protection, tariffs, and the power of labour, then perhaps it will also drive up inflationary pressures for goods as opposed to assets.

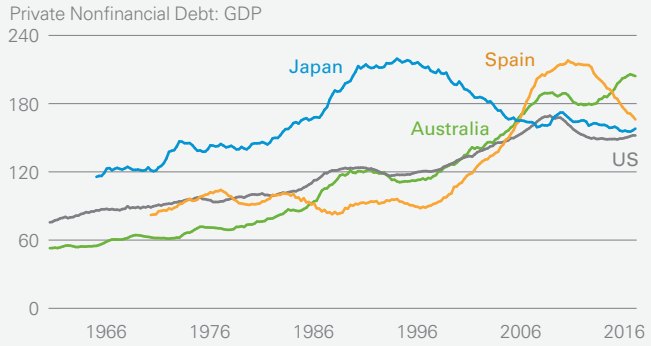
How Will the Current Cycle Likely End?

We are at a confluence of deflationary and inflationary forces. The deflationary forces of debt overhang and demography are considerable. The Japan example illustrates that not even expansionary monetary policy can necessarily solve these problems. Yet, against that, we are in the midst of perhaps one of the greatest peacetime expansionary monetary policy experiments. This is clearly applying significant inflationary forces to the economic environment.

When two such strong, opposing forces exist simultaneously, the net outcome is clearly uncertain but we would observe that:

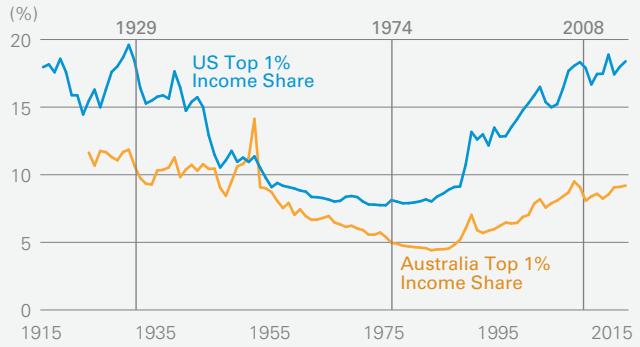
1. Inflationary policies (the monetising of deficit) are popular and austerity is unpopular. In fact, monetised deficit spending is the ultimate politician's free lunch—largesse may be bestowed upon voters without the need for unpopular taxes or increases in debt.

Exhibit 2
Debt Cycles Turn



As at December 2016
Source: Lazard, Bank of International Settlements

Exhibit 3
Social Cycle – Crisis of Capitalism and Globalisation



As at December 2015
Source: Minack Advisors https://legacy.voteview.com/political_polarization_2014.htm, Prof. Saez http://eml.berkeley.edu/~saez/

2. For monetary authorities, deflation is not an acceptable outcome. As the former Fed Chair Ben Bernanke explained in his famous 2002 "helicopter" speech, the Fed has the ability to prevent deflation, given that they have unlimited control over the money supply. Finally, inflation is the only way indebted governments will be able to meet their obligations. This dynamic includes Australia, where government debt levels (albeit from relatively low levels) continue to rise and both major political parties have appeared to abandon serious fiscal discipline in the short term.

These arguments imply that the final outcome of this global debt cycle should be inflationary, but it does not reveal the potential timing of this scenario. Consequently, while we do not anticipate inflation, we believe prudent investors should prepare for a range of possible outcomes.

We do not believe that we can foresee inflation outcomes, but we do believe that a prudent investor should be prepared for a range of possible inflation and interest rate scenarios.

Does Inflation Matter?

What would inflation mean for the Australian economy and the equity market? To answer that, it helps to consider our starting point today from both a global macro and local markets perspective (Exhibit 4).

The first observation is that most of the world, including Australia, has negative real policy rates measured on spot and even more negative policy rates if considered in light of central bank inflation targets. Thus if economic conditions were to "normalise," we would experience rate rises, even without any rise in inflation. The bias is clearly on the side of rates rising from current levels.

The second observation relates to the valuations of the major asset classes. In particular, we need to ask the critical question: "Which assets are priced on negative real spot interest rates and which ones are not?"

We view equities as being on the expensive side of fair value, but not dramatically so. The pre-tax earnings yield of approximately 7.5% in the stock market is in line with the average over the last 20 years.

In contrast, bonds, by definition are priced on the current spot rates, with the ten-year bond yielding around 2.35%. Based on our assessment, residential property, also priced on current spot rates, appears to be at least 75% overvalued and has a pre-tax yield of around 2.3%.

It is clear that there are signs of speculation, including very high investor participation, and widespread interest-only borrowing in this market. The price-to-income multiple in Sydney now stands slightly above that of Tokyo in late 1989 just before the property bubble burst.

Scenarios

For Australia, the sheer size of the residential property market ($7.5T) and its dominance of the household balance sheet makes it a critical factor in assessing possible outcomes from a rise in inflation.

One would normally consider four possible growth/inflation scenarios:

- **Stagflation** – low growth, high inflation
- **Japanese Experience** – low growth, low inflation
- **It's all OK** – Good growth, low inflation
- **QE wins** – Good growth, high inflation

Yet in Australia, a rise in inflation and an associated rise in interest rates we believe would most likely result in a crash of the residential property market. At Reserve Bank of Australia cash rates were only 2.5% (up from the current level of 1.5%), for example, households would be devoting about as much to mortgage payments as they did in the late 1980s when variable mortgage rates reached the high teens. A rise of the cash rate to 5%—a number broadly consistent with a 2.5% inflation target and nominal growth of about 2.5%—could lead to widespread mortgage distress and defaults.

Exhibit 4
A Starting Point

(%)	United States	Germany	Australia
Unemployment Rate	4.3	3.9	5.9
3-Year Change	-2.0	-1.0	-0.4
Real Interest Rate	-0.6	-2.0	-0.6

Australia Equities (S&P/ASX 200)	Pre-tax earnings yield of 7.5%
Australian Government Bonds	10-Year pre-tax yield of 2.3%
Australian Residential Property	Ungeared pre-tax yield of ca 2.3%

As at May 2017
Source: Lazard, Goldman Sachs, UBS

It is thus likely, in our opinion, that a rise in inflation would be followed by a deep recession and a return to very low inflation or deflation. Clearly, Australia's extreme household debt levels make the economy very vulnerable to high inflation, which should be a serious concern for investors.

Potential Impact on Australian Equities

What then does this mean for equities in Australia? An inflationary environment would mean very different things for different areas of the economy. This is particularly true if the current starting prices for sectors are taken into account.

Assuming a local rise in inflation and subsequent recession, from a broad sector point of view, the biggest risk in the S&P/ASX 200 Index appears to be in the banks and domestic cyclicals—both of these industries are heavily exposed to the high consumer debt levels. While the biggest beneficiaries we believe would be global exporters, who would theoretically become more competitive from a lower exchange rate and reduced wage pressures that would likely occur in a recessionary situation (Exhibit 5). It should be stressed that not every company in these broad groups would be affected to the same degree, as each company is different and importantly is trading on a different valuation. Security selection will remain critical, both in terms of sectors and the companies within these sectors.

We should also point out that if the entire world experienced inflation, any benefits to exporters would be eliminated. Yet given that Australia did not participate in the global financial crisis and has much higher consumer debt levels, Australia would likely experience a worse downturn and larger deflationary pressures.

Exhibit 5
High Inflation: Winners and Losers

Strong Positive	Positive	Neutral	Negative	Large Negative
Exporters	Global Industrials	Non-Bank Financials, Domestic Defensives	A-REITs & Infrastructure	Domestic Cyclicals, Banks

For illustrative purposes only.

Thus, even in this scenario, it is likely that the exchange rate would be weak, partially offsetting the adverse impacts for global businesses (such as Brambles and Amcor) and assisting exporters (such as Rio Tinto or Cochlear).

In an inflationary outbreak, we would expect the Australian stock market to fall, but given that it is a real asset class with a fairly reasonable starting valuation, it may be—at least in the medium term—a relatively better option compared with nominal bonds and residential property. While the bank and cyclical sectors together account for approximately 40% of the market, this is not a binding constraint on an active manager of equities.

Plan for Inflation

There are two kinds of forecasters: those who don't know, and those who don't know they don't know."

— John Kenneth Galbraith

Macroeconomic forecasts are notoriously unreliable, and what we have known about inflation has been upended in the last 20 years. So we make no predictions about the timing of a return to inflation. Yet we still believe equity investors should consider inflation risk within an asset allocation framework. Our view is that inflation is a more likely outcome than deflation over the long term. Equities can serve as a hedge against inflation, but in Australian equities today in particular, investors should be very selective in terms of stock selection.

This content represents the views of the author(s), and its conclusions may vary from those held elsewhere within Lazard Asset Management. Lazard is committed to giving our investment professionals the autonomy to develop their own investment views, which are informed by a robust exchange of ideas throughout the firm.

Notes

1 Friedman, Schwartz. *"A Monetary History of the United States 1867–1960," University Press, Princeton University, 1963.*

Important Information

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