The Market in Review

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This week's articles and insights

1. *A Divided World*
2. *A Conversation About Inflation*

"Inflation is when you pay fifteen dollars for the ten-dollar haircut you used to get for five dollars when you had hair."

\- ***Sam Ewing***

Your Index Report

	Current	Last Week	Year-to-Date
Dow Jones Ind. Avg.	26,026	- 0.02%	+ 11.57%
S&P 500	2,804	+ 0.39%	+ 11.84% (+8.93% in $CDN)
TSX	16,068	+ 0.34%	+ 12.19%

This week's letter addresses a longer-term topic. But first, a look at conditions today.

A Divided World

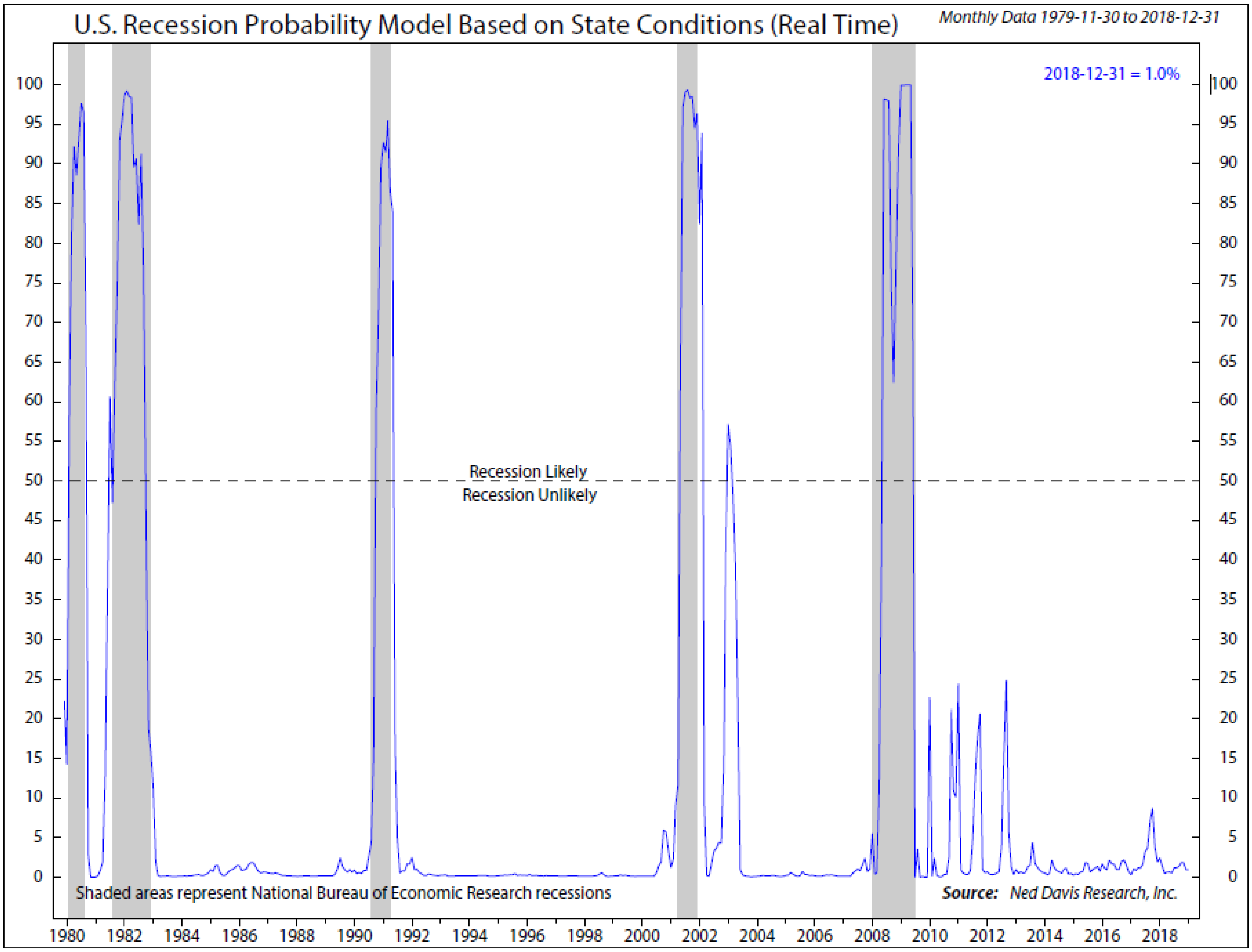
It is a confusing time in world markets.

On the one hand, you have the United States performing quite well in comparison to the rest of the world:

Industrial Production

	January Forecast	**Actual January**
US	3.6%	**3.8%**

Recession risk within the next 12 months, as measured by adding up the risk in each of the 50 states, is hovering at only 1%:



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However, things are not nearly as rosy in the rest of the world:

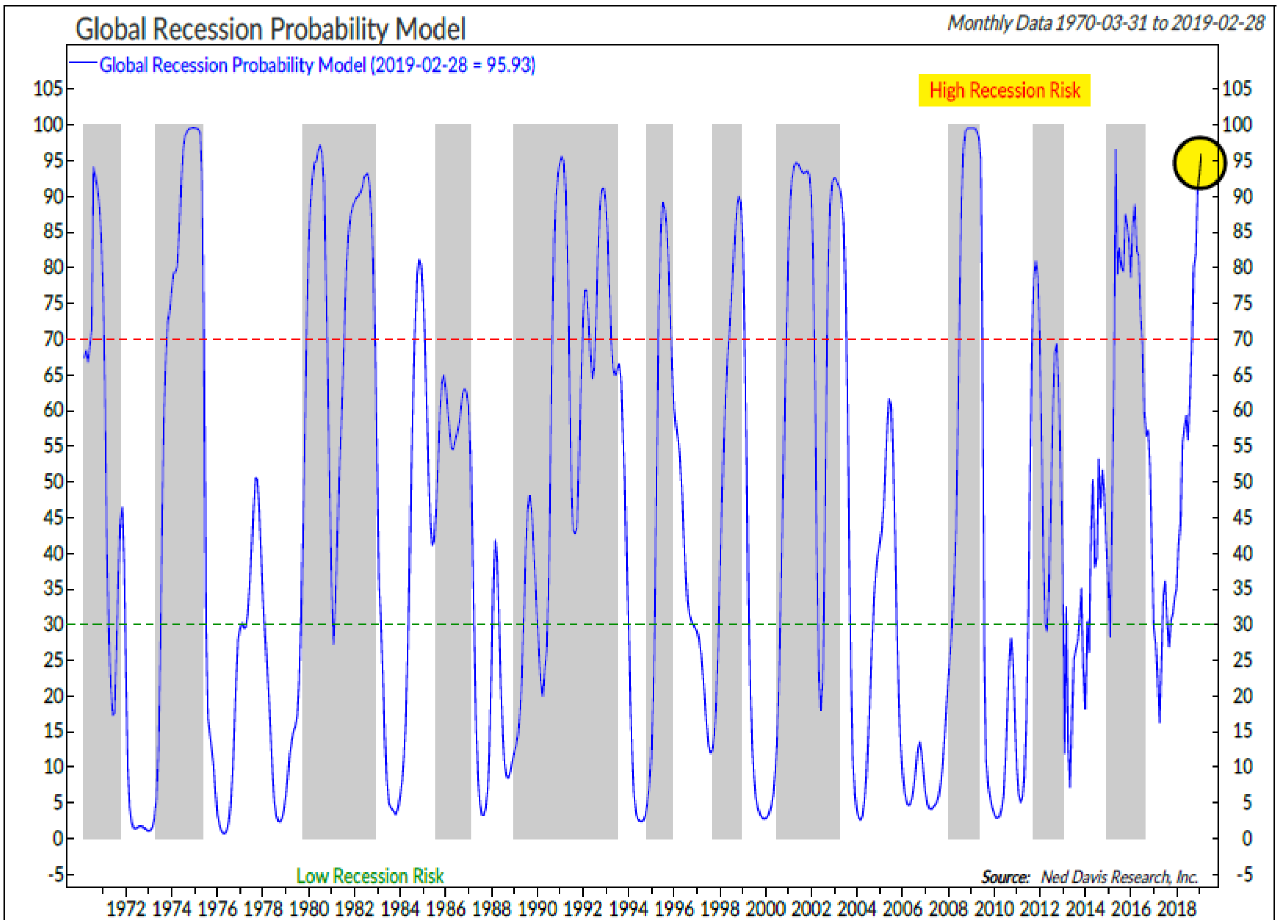
Industrial Production

	January Forecast	**Actual January**
South Korea	1.2%	**0.1%**
Japan	-2.5%	**-3.7%**
Germany	0.7%	**-0.4%**

Source: Trading Economics

Economic numbers out of China and Canada also point modestly lower in January, although final numbers are not out yet.

And recession risk is very high. In fact, much of the world outside North America may already be in a mild recession:



Shaded Areas Represent OECD-Defined Global Recession Periods

Analysis Dates: 1970-03-31 - 2019-02-28		
	Actual:	
Probability Model	Recession (% of Time)	No Recession (% of Time)
Above 70	89.74	10.26
Between 30 and 70	50.25	49.75
Below 30	15.74	84.26

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Before we get too worried, there is little credit stress in the world. This means we don't expect anything close to the recession we saw in 2008-2009, if and when one arrives. In fact, it could be quite mild, especially with unemployment so low due to retiring Baby Boomers and the growing need for skilled employees.

One commentator recently postulated that “this could be the first recession where nobody loses their job.”

Markets have been rather euphoric since the sharp December decline, even as economic conditions are deteriorating in most countries. The US remains the bastion of growth, with the S&P 500 index rising a full 20% since the December 24th lows. That is already a great year by any standard.

We have been expecting some sort of pullback for several weeks now, although markets have, so far, refused to bend. Many managers are in the same boat – sitting on cash and afraid to invest it.

Trade discussions between China and the US have shown progress recently, which may explain some of the optimism in stocks. The next increase in tariffs that was to have started March 1st has been shelved. There is also progress on the mechanization to enforce a future trade deal, which suggests one is getting closer.

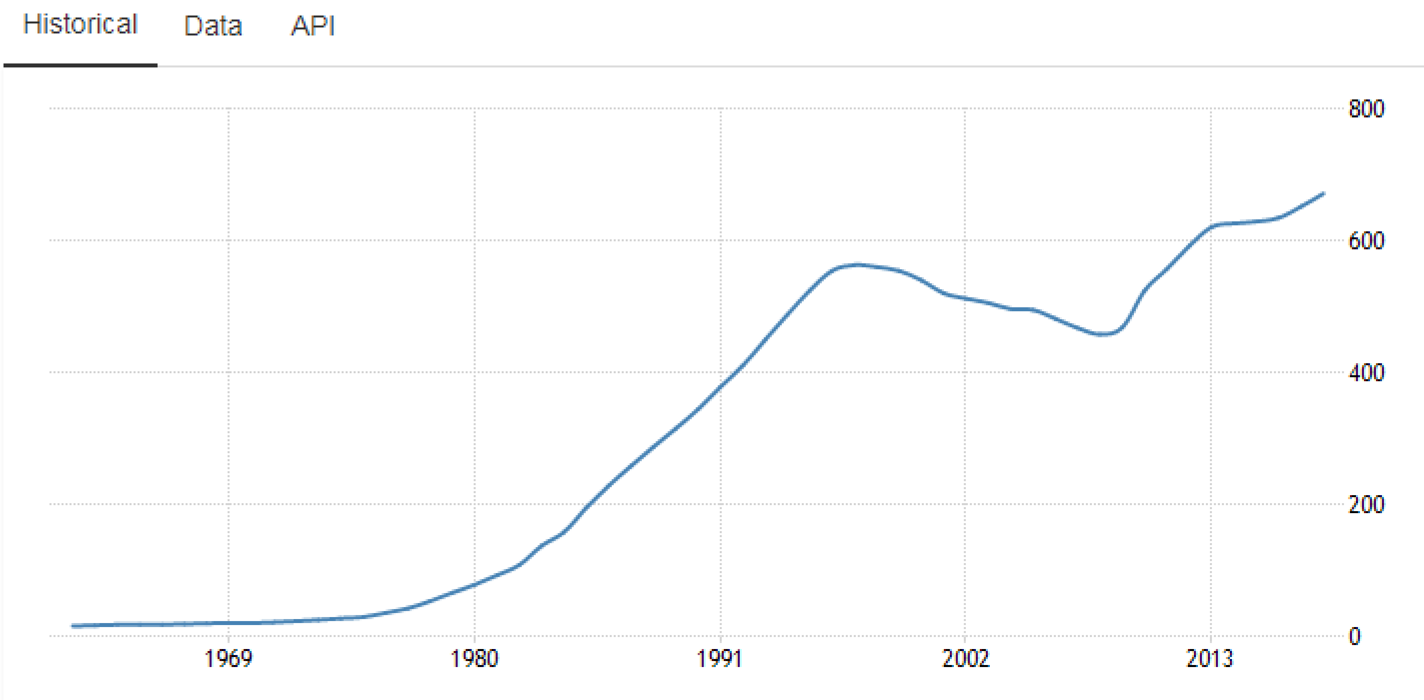
Any trade agreement would help reverse the downward slide in global industrial production.

Inflation

A question that has come up repeatedly over the last decade is “how do we pay all this debt off?” Governments used to get voted out because of rising deficits, and we once shook with horror at spending a billion dollars more than we took in.

Canada projects a deficit of $18 billion this fiscal year and the US expects to overspend by almost $1 trillion (yes, with a T). We used to claim that deficits in bad years would be offset by surpluses in good years but, of course, this never happens. And with interest rates so low, we can carry a great deal more debt without feeling much pain.

This chart shows the Government of Canada’s accumulated debt nearing $700 billion. We love spending. Paying it back? Not so much.



Source: Department of Finance, Canada

“Dad,” my son says to me a few weeks ago, “I just found out that I owe $32,000.”

We have raised Ray to be very conscious of credit cards and debt, so this was a shock.

“Excuse me?” I replied.

“It’s my share of Canada and BC’s accumulated debt. Each of us owes $32,000. And it is growing at $500 per year – that’s $50 million per day – mostly thanks to your generation.” He looked at me with accusing eyes. “So who is going to pay that off, dad?”

I felt a little sheepish as I told him the truth.

“You will, Ray. Or your generation will. My generation will be largely gone in the next 30 years. By that time, the federal government is expected to more than double its current deficit. We already spend $64 billion per year just on interest, which is more than we spend on schools. Interest rates are low now, but they won’t always be. Makes me glad I’m old!”

He didn’t laugh.

“Didn’t you always tell me it was best to pay off your debt as fast as possible, dad? Sounds like your generation doesn’t follow its own advice.”

“Sadly, you’re right,” I admitted. “But you do get free health care!”

“Probably not when I’ll need it. I’ve been to the hospital once in my life – when I was born – and it’s you old folks who have overused and underfunded our medical system. So explain to me how the government really plans to pay this off.”

And so begins my discussion about how this ends.

1. We can raise taxes and cut spending so that we actually pay down our accumulated debts. Look again at the chart above and see how well we’ve done in the good times. We paid a little off from 1997 to 2006, then added it all back and more after the 2008 recession.
2. We can default, as some companies did in 2008, many banks did in 1932, and entire countries did after World War 2. This is the most severe way to erase debt and these are all calamitous events. You can’t really plan for them and no one wants to.
3. We can inflate the debt away. This is the most painless, invisible, and cowardly way to do it, which means it is the most likely. In fact, it has been going on for a very long time.

A little history here.

Most people know Sir Isaac Newton as the man who discovered gravity and the inventor of calculus. He was also obsessed with alchemy and sought ways to transmute lead and mercury into gold, without success. When he was asked to become head of the British Mint, he already knew how pure and immutable gold was from his experiments, so he devised fixed ratios to set the British pound on a gold and silver standard. This led to its becoming the most solid currency in the world for a period of over 200 years. Its value never wavered.

As the 20th century began, supplies of gold started to become insufficient to back all the paper currency in the world, so central banks were created to “manage” the currencies. The US Federal Reserve began in 1913, and that is when the inflation fun started.

“Inflation is as violent as a mugger, as frightening as an armed robber and as deadly as a hit man.”

- *Ronald Reagan*

Inflation is the steady devaluation of your currency. Your cash. This means 2% inflation makes your $1.00 in January worth just $0.98 in December. And then $0.96 the year after that, and so on, and so on.

It is a marvelous way to whittle down debt. The Government of Canada’s accumulated debt of $600 billion will be devalued to $588 billion in a year’s time, with 2% inflation. Why 2%? Because that is the official inflation target of most central banks.

Since the US Federal Reserve was created to ‘manage’ the currency, inflation has averaged 3.13% per year. It is lower today, but higher in the 1970s.

This means $1.00 in 1913 is now worth just 4¢, thanks to inflation. Cash is only a good investment for short periods of time. Over the long term, it erodes far too quickly.

To lower the huge accumulated debts worldwide, central banks know they only have one workable solution: to let inflation run higher. If they can. With an aging population and slowing growth, inflation is proving harder to ignite than first thought. But, keep faith in your government – they will find a way!

For the record, what held its value in a world where cash devalued year after year? This comparison shows what $1.00 was worth in 1913 and what it is worth today, compared to other asset classes:

Equivalent purchasing power from 1913 to 2018:

	1913	**2018**	
Cash	$1.00	$ 0.04	Cash declined at the inflation rate of 3.13% per year, on average.
Gold	$1.00	$ 2.48	Gold held its value, plus a little more, after inflation (growth of 4% per year).
Bonds	$1.00	$ 4.97	Bonds returned 4.7% per year, so also managed to outperform inflation by a small margin.
Stocks	$1.00	$1,087.00	Dow Jones Industrial Average, with dividends reinvested – a return of 10%, or 6.7% after inflation.

The only thing that grew at a rate that was remotely close to stocks was income taxes! They were essentially zero in 1913, and then grew steadily after the wars.

Ray Dalio, the most successful hedge fund manager in the world, describes orderly inflation as the “beautiful deleveraging”. Done steadily, it is the least painful way to pay off debt.

I continue with my son’s discussion:

“Britain did this after WW2, Ray. They won the war, but lost the peace. Victory came at a horrendous cost. They let the pound sterling decline a little every year through inflation. Over twenty years, the debt in real terms got whittled down. Now, living conditions were tough. Costs for food and housing rose, and there were a lot of strikes for higher pay to keep up. Every service, from hospitals to the army, atrophied. But the debt was reduced by eroding it bit by bit.”

“Not a great inheritance for my generation, is it?”

“When your generation gets elected, you can start sticking it to us with higher estate taxes. We’ll all be in retirement homes and won’t notice.”

“And own assets that keep pace with inflation,” I concluded. “Keep that 1913 to 2018 list close to your heart!”

Thank you for your referrals this month! They are always handled with great care and discretion.

http://www.dividendvaluepartners.com

We thank you for your business and your referrals and we hope you find our site user friendly and informative. We would welcome your comments.

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Prices shown are as of close March 1st, 2018.