

Pensions: When debt balloons - inflate

BRAVE Partners has been predicting that inflation will rise sharply for some time. This is now showing in the reported figures from petrol stations and supermarkets. It is time for pension funds to position themselves correctly for a bout of unchecked inflation.

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The inflation genie

Inflation is a necessary part of a capitalist economy. It is one of the drivers of consumer spending. In a deflationary environment, people delay spending as they can get the items cheaper later. The flow of money stops and with it the economy.

Too much of a good thing

However, hyperinflation is bad. In a hyper-inflating environment, money itself becomes worthless. One of the most memorable examples of this is from the Weimar Republic, the inter-war German government, where there was hyper-inflation. In 1923 the Weimar Republic inflation rate was 3.25 million percent a month, which meant that prices doubled every two days. One story that has emerged is about two ladies who went shopping with a basket full of money. They left this outside a shop as it was too bulky to carry in. When they emerged the basket was gone, but the money was left.

Hyper-inflation can generate some interesting behavior. One story that has emerged from inter-war Germany (the Weimar Republic) is about two ladies who went shopping with a basket full of money. They left this outside a shop as it was too bulky to carry in. When they emerged the basket was gone, but the money was left.

Governments seek to keep inflation under control so that the currency (money) continues as a means of exchange and the economy continues to function. However, there is a state of the economy that is worse than high inflation: that is deflation.

Deflation

In a deflationary environment two things happen.

- Consumers delay spending.
- Debtors struggle as the real value of their debts rise.

Deflation is therefore highly damaging to the economy. This has been demonstrated in Japan where the country has struggled to pull out of deflation for a decade, whereas hyper-inflation tends to be a short lived phenomenon (unless embedded in the rule of an unstable despot).

Get real

UK pension schemes need to worry about inflation because their liabilities are linked to inflation. Strictly speaking, pension schemes are exposed to the difference between government bond (“risk free”) interest rates and inflation rates. This is the so called real interest rate. It is the real interest rate as it reflects the true increase in spending power that is achieved by saving. Savings earn interest, but a delay in purchasing also exposes the saver to rising prices – ie inflation. The saver is only better off from delaying purchases by the difference between the interest paid and the inflation in the price of the goods.

Pension trust exposure

Pension trusts are exposed to falling real interest rates. Just like the saver, the pension trust receives the interest on its investments, but pays out benefits that are linked to inflation. So while a pension trust does not buy any goods directly, its payments are still inflation linked.

The real world

It is rare for inflation to run ahead of interest rates. Under normal economic circumstances interest rates are used to control consumption by incentivising people to delay purchases. As inflation rises, usually driven by an increase in consumption, interest rates are pushed up to incent people to delay purchases. Interest rates will therefore tend to rise with inflation and real interest rates will also tend to rise with inflation. Many central banks, including that of the UK, are tasked with meeting an inflation target – so this should almost be an automatic reaction.

The unreal world

Economic conditions have driven real interest rates negative. This is extremely bad for pensioner and pensions. In the current conditions interest rates are low, so investment income is low, but inflation is high – so pensioners’ expenses are rising fast. These conditions are unusual and increasing inflation should normally push the central banks to raise interest rates. This has not happened. Although the voting split is getting narrower, the Bank of England has kept UK interest rates at 0.5% for around 2 years, despite a rise in inflation from around the target 2% level to about 4.5%. To date, the Bank of England has resolutely kept rates down and written the required letter to explain why they have missed the inflation target.

Inflation in the developed economies is driven by rising taxes and commodity prices. It is fundamentally different to the traditional inflation driven by supply side tightening.

Factors driving inflation

The globalised economy has changed the face of inflation. Previously inflation has been driven by home driven consumption. The dynamic was centered around output capacity. As consumption rose it could be met until consumption became close to the output capacity of the economy. At that point prices began to rise creating inflation in a fully employed economy, so workers would then look to push up wages to meet rising prices. This would create an inflationary spiral. Using interest rates to persuade

people to defer spending would relieve pressure on production, allowing it to catch up by either increasing in size or efficiency.

An import economy

Over the past decade, the global economy has shifted. Manufacturing has shifted from many economies to the emerging markets. China was the original destination of choice, but as demand increased and with it prices, Vietnam and Cambodia joined in. India has also become the home of outsourced services. Call centres and IT businesses cover parts of India. All of this has driven wealth, and with that consumption, in Asia.

The import economy has kept inflation down for a decade or more. Production has increased rapidly without driving up wages because globalisation has tapped into vast supplies of cheap labour in Asia. However, now a new limiting factor for the global economy is emerging – resources.

Resourceful

Global consumption has risen. Abundant cheap supply has both driven demand in the developed economies and created wealth in the emerging economies that is feeding through to domestic demand there. All of this drives a consumption of resource – both raw materials and energy. It is the prices of these commodities which continually hit all time highs that are driving inflation.

Global inflation is being driven by the price of resources – commodities and energy. Consumption in the developed economies has fallen sharply and is unlikely to rise in the near term.

Crunch

The developed economies rode a wave of credit driven consumption. Asset values rose sharply with perceived wealth. Lenders would finance asset purchases against an assumed backdrop of rising prices. The view became that the creditworthiness of the borrower was almost irrelevant. If the borrower defaulted, the lender would recover the loan by selling the asset. Inflation was hidden in asset values.

De-railed

The credit boom eventually derailed – spectacularly – and the developed economies have begun the slow, painful process of repaying their debts against a backdrop of stable or falling asset values. These economies are weak. Consumers are struggling with debts. Employment is weak and unemployment is high. Spending figures splutter higher from time to time, but overall the trend is down and figures are weak. Consumption in the developed economies are not driving demand and inflation.

Risks of a rise

Raising interest rates will drive many borrowers into default. This will put additional downward pressure on both asset prices and the economies. Central banks have a major dilemma. Inflation means that they are expected to raise rates. However, rising rates might well completely de-rail a fragile economy and not tackle the imported inflation.

Interestingly, the rate rise question is more of an issue in the UK where the Bank of England has a single inflation target. In the USA the Federal Reserve has a dual target of inflation and maximizing employment. This means that the Federal Reserve is less likely to take any action which it believes will substantially slow the economy.

The biggest borrowers of them all

Moreover, whilst the central banks are technically independent – it will be clear to them that moderate inflation will assist the biggest borrowers of them all – the Governments. As events in Greece, Ireland and now Portugal are demonstrating – Governments are struggling to repay their debt. Inflation is good for debtors. Debt is a fixed value. The relative value of this debt reduces as prices increase. Overall Governments will want moderate inflation to help manage their own debt.

Guilty

As pension funds are one of the most significant owners of Government debt, they are set to bear the burden of the inflation. It can be viewed as a transfer of responsibility for repaying the debt. In many ways it will impact the same people – current taxpayers. It is just a case that eroding pension values is less obvious than increasing taxes.

All bonds

Warren Buffet appears to share these views. He has recently commented that investors should be seeking to own businesses for the long term, rather than invest in long term (US) bonds. He believes that in the long term, fixed income asset values will be eroded.

Low rates and moderate inflation to stay

BRAVE Partners believes that the current environment will persist for some time. Global shortages are driving commodity prices. Inflation is being further compounded by tax rises which are proving necessary for Governments to service debt. In the UK, inflation ticked up in January 2011 with the increase in VAT, the local sales tax. Global disasters are also impacting commodity prices. Coal prices had been driven substantially higher by the floods in Queensland, Australia – even before the earthquake in Japan and the ensuing problems with the Fukushima nuclear plant.

Energised

Energy appears to be at the core of inflation. All economic activity requires energy. As economic activity has spread over the globe, so has energy demand. Developed economies have already identified an impending energy shortage. Nuclear was becoming seen as the solution – and it probably still is. However, nuclear development has clearly been delayed by the meltdown in Japan. (As, I write this the BBC news, in the background, is reporting that Japan is advising all people who live within 18 miles of the Fukushima plant to move away.) This delay can only add more pressure to energy prices.

Energy will be a key driver of inflation and a key investment priority for the next decades.

Christopher Cloke Browne
Managing Partner
BRAVE Partners LLP

Energy will be a key driver of inflation and a key investment priority for the next decades. In the opinion of BRAVE Partners, solving the energy crisis is the key to ongoing prosperity.

Pension investments

As early as 2009, BRAVE Partners was suggesting that pension funds invest in equities and not bonds due to inflation concerns (see "[A scheme to give me my pension at 65](#)"). At that time the firm suggested investment in energy as a pension fund strategy (see "[Is now the time to have an inflated expectation of your pension fund?](#)")

If anything, the firm's recommendation of investment in energy is only more vigorous now, in 2011, than it was in 2009.

The right energy

However, energy investments are not without risk. There are still many that are highly speculative. Many technologies are not proven as long term economic, or even viable. However, some attract huge valuations as the industry rolls through a series of trends and fashions (see "[The Va Va Voom of biofuels](#)" for comment).

Pension investments need to be for the long term and cash generative. Finding the right, commercially viable, technologies is essential to this.

BRAVE Partners' services

The BRAVE Partners have a strong engineering background. The firm maintains a strong scepticism of many alternative energy technologies. This has meant a slower growth for the firm's energy business. However, over the first months of 2011, BRAVE Partners is identifying a core client base with strong commercially and technologically viable alternative energy business.

The firm can assist pension funds and their investment advisors to evaluate these businesses and technologies. This will assess the impact that they might have on the inflation risk to the pension schemes which must be rising by the day.

Interaction

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- The current economic climate is highly erosive to the value of pension funds.
- BRAVE Partners believes that this situation will persist.
 - The inflation factors are structurally different to traditional inflation which can be suppressed with interest rate rises.
- The firm believes that energy prices will be a key factor in keeping inflation high.
- BRAVE Partners LLP advised pension trusts to invest in energy assets back in 2009.
- The firm believes that the case for pension trusts to invest in energy business and assets is even more pressing in the current market.
- There are many alternative energy business and technologies that are highly speculative.
- BRAVE Partners can advise pension trusts and their investment advisors on the alternative energy market and solid sustainable business opportunities within it.

enquiries@bravepartners.com

www.bravepartners.com

OFFICE: +44 1962 808099

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