Inflation is coming, so plan accordingly

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WEALTH MANAGEMENT

By Paul Tyers

Since late 2008, prudent investment managers have been progressively moving away from cash and government bonds and gradually increasing exposures to select developing markets and cyclically-oriented sectors.

While that is hardly a consensus strategy when judged by the financial press, if conviction led managers to move down the risk curve when valuations were historically high, the same convictions should lead a move in the other directions when valuations are lower and inflation is looming. However, if a decision has been made to take advantage of attractive valuations it remains prudent to re-emphasize diversification, risk management and a long-term global perspective.

Up to around mid-May, Canadian, U.S. and MSCI indexes were up 36 per cent, 37 per cent and 26 per cent each from their March lows. So since the point of maximum pessimism, there has been a sizeable bounce-back in the markets.

Recall that by the end of the first quarter of 2009 the TSX had declined 32 per cent in 12 months. The S&P and MSCI indexes also lost 8.25 per cent and nine per cent respectively for the quarter, bringing the 12 month declines to 24 and 29 per cent, respectively.

Major Canadian pension funds also reported their 2008 results during the quarter with the pension fund index down 18.4 per cent, and the mighty Caisse de dépôt et placement du Québec down 25 per cent.

It's instructive to compare the recent investment environment with that of a decade ago. In 1999, stock markets were wildly overpriced (remember the NASDAQ trading at over 5,000 points?) and everyone wanted to buy. Near universal optimism reigned. Strategists presenting a less favourable analysis were dismissed as unnecessarily gloomy.

However, in retrospect, those calling for a period of low returns were right — 1999 was a time to stay close to shore and reduce portfolio risk. But how many investors pursued that type of strategy?

Now, let's fast-forward a decade to March 2009. In many ways, we had the exact opposite situation as compared to 1999. After declines of over 50 per cent since their 2008 highs, equity markets around the world were attractively priced based on a variety of fundamental valuation measures. But investors were unwaveringly unified in their pessimistic outlooks.

Looking ahead to the next several quarters, and even years, should investors expect more of the same?

Despite the economic slowdown, coupled with significant job loss in the auto sector and supporting industries perhaps it's a good time to be looking at the history of bull markets following bears. If history repeats itself, heavy weighting in fixed rate securities may not be the place to be.

So, what assets should portfolios be targeting for the current environment? Perhaps the seed to this answer lies in the avalanche of policy actions by governments and central banks, flooding the global financial system with money supply. The ultimate result will no doubt be serious worldwide inflationary effects, eroding the real value of fiat currencies.

In that environment, loading up on cash and government bonds (as many investors have been doing) to seek safety and stability will almost certainly prove to be a misguided portfolio strategy. Instead, a focus on inflation insurance policies and protection against inevitable currency debasement is now essential. This environment has historically been good for hard assets and commodities.

While developed countries have been hurt in the credit crisis, so-called 'emerging' economies, such as China, India and Brazil, will play a much larger role in global economic and financial developments. Although these markets are also experiencing painful dislocations, they will prove to recover better and more quickly from the current situation.

Why? For one, consumer debt levels are low and their banking systems are not going through the same crises as many parts of the industrialized world. Enormous resources are also available to stimulate domestic demand, offsetting shrinking exports. In particular, China has over US$2 trillion in reserves and one of the world's highest savings ratios. Even now, key emerging economies are showing signs of stabilization in growing lending figures and increasing demand for commodities.

For success in portfolio management, it is important to conduct our analyses free from emotion, basing decisions on forward-looking views. The world is witnessing the most acute financial crisis since the Great Depression. Global economic news is bleak and the Organization for Economic Co-operation and Development expects advanced economies to contract by 4.3 per cent in 2009 and one out of 10 workers to be unemployed by 2010.

We are clearly in tough economic times. However, it is important to understand that speculative excesses have already largely been purged from the system and much of the adjustment is behind us.

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