Equity Valuation

Inflation, deflation and mean reversion

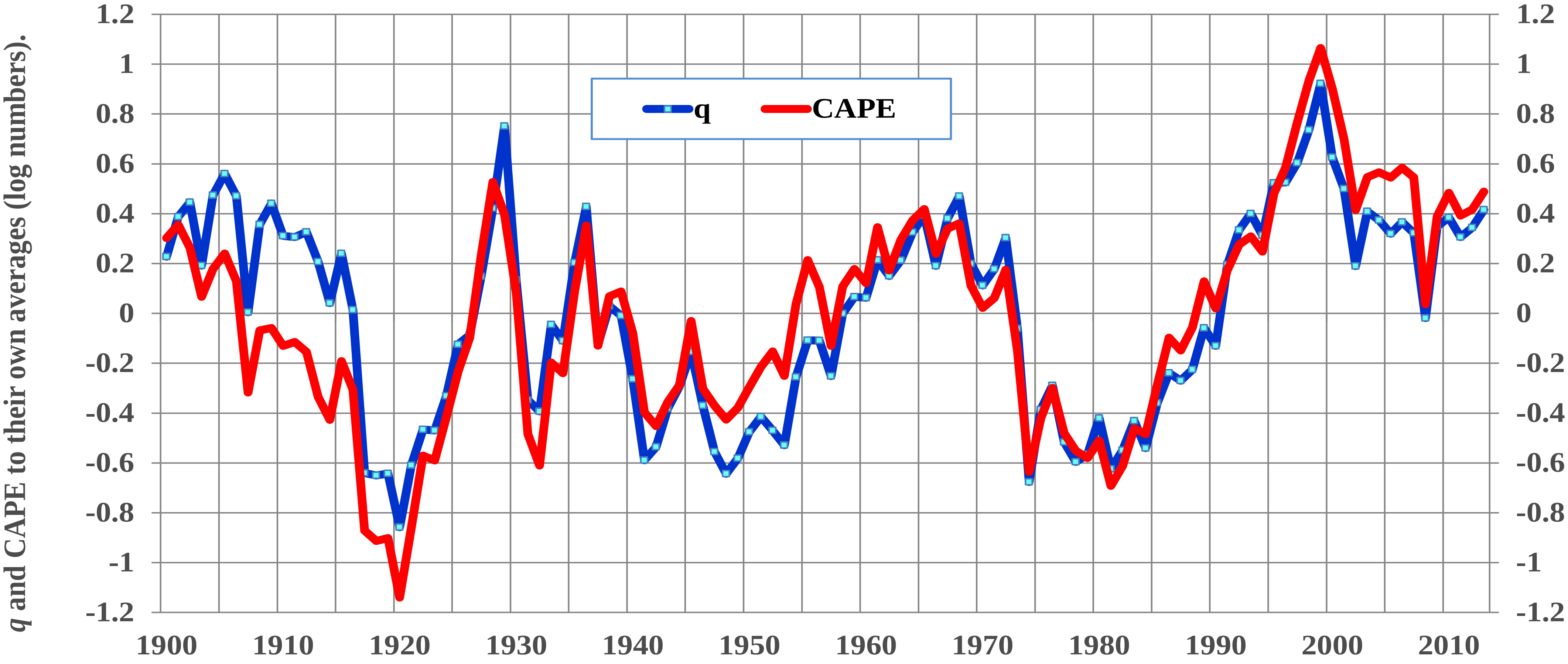
Russell Napier
Strategist

Conclusions

- Key to mean reversion of CAPE- changing inflationary expectations
- CAPE and Q drive capital creation and are reflexive
- Technology is key but it is never as positive for non-inflationary growth as it seems
- Deflation or inflation rising through 4% will reduce valuations
- Equities can adjust more rapidly than bonds
- Deflation comes next and sharply lower equity prices

The mean reversion of CAPE

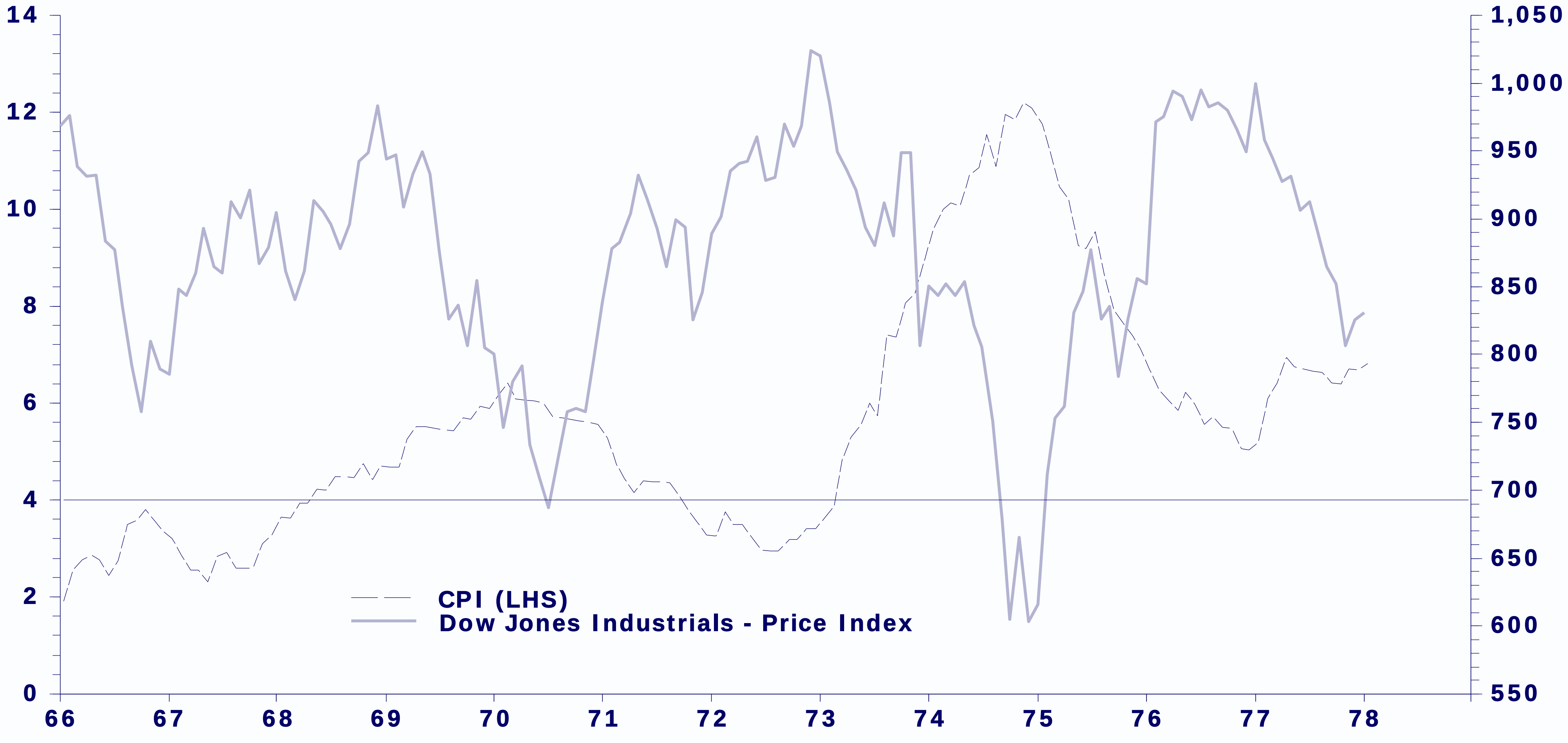
Slide 4. US Stock Market Value *q* and CAPE.



Data Sources: Stephen Wright (1900 - 1952) and Federal Reserve Z1 Table B.102 (1952 - Q2 2013) for q, and Robert Shiller (updated) from Standard & Poor's for CAPE.

But beware inflation near 4%

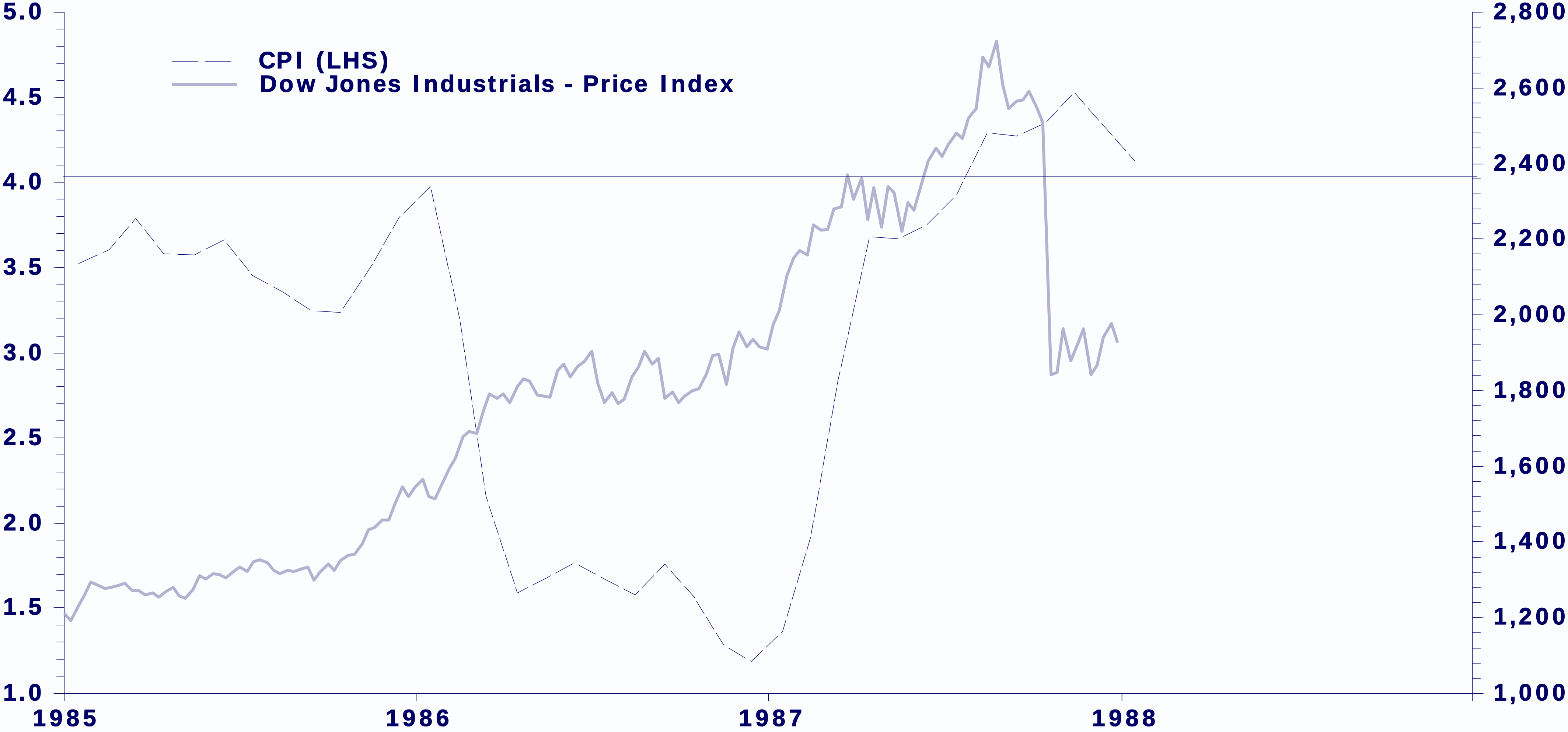
US inflation and Dow Jones Industrial Average, 1966-1978



Source: Datastream

But beware inflation near 4%

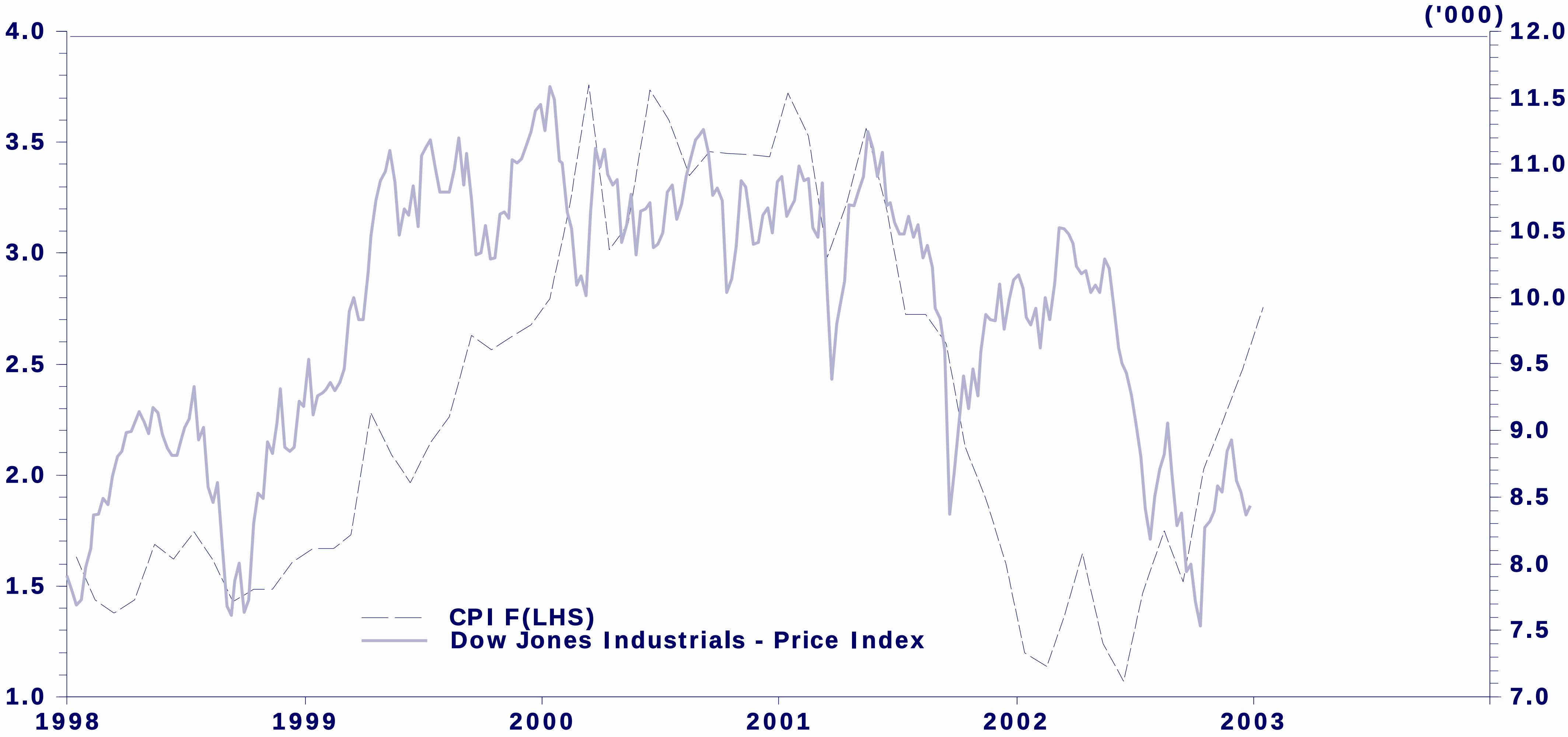
US inflation and Dow Jones Industrial Average, 1985-1988



Source: Datastream

But beware inflation near 4%

US inflation and Dow Jones Industrial Average, 1989-2003



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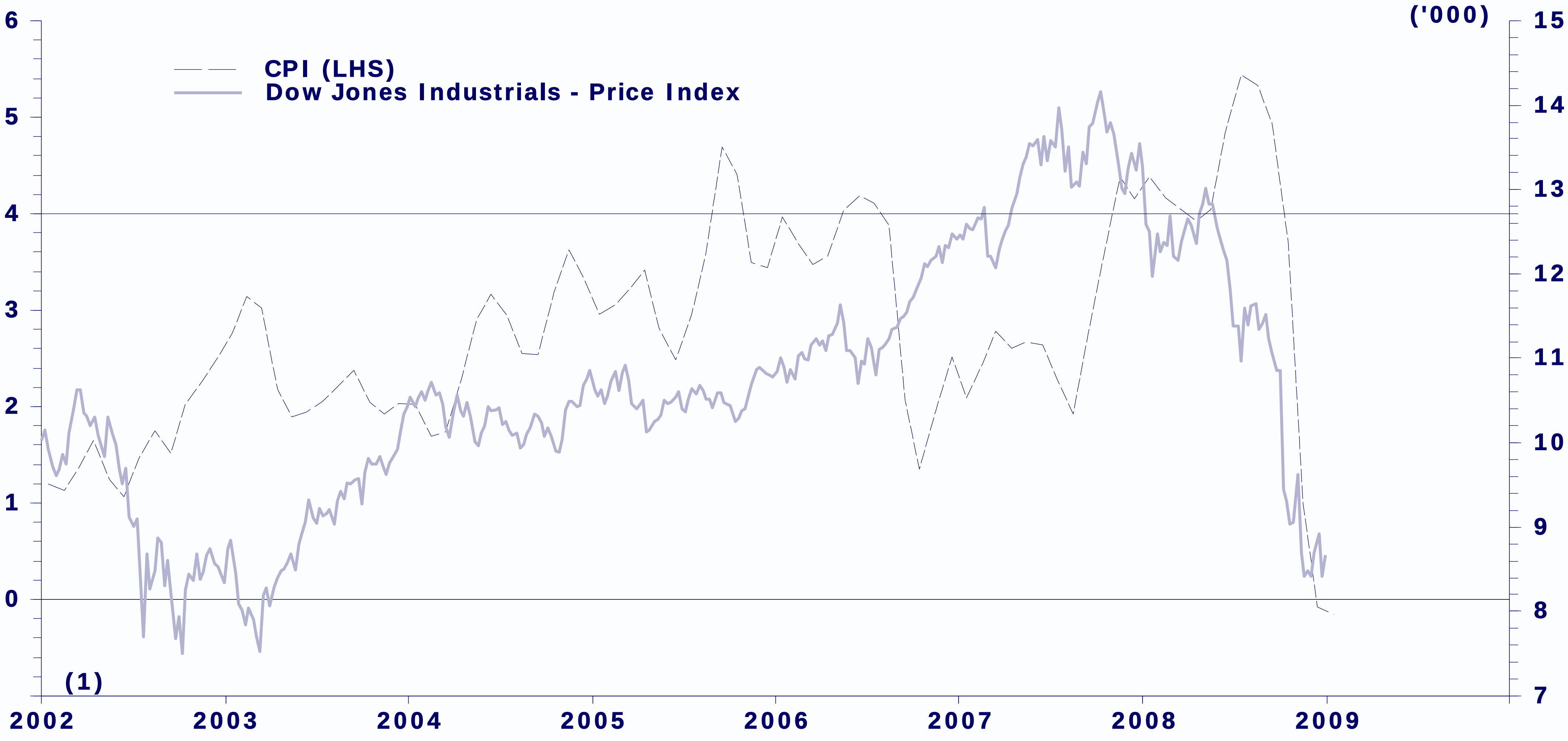
But beware inflation near 4%

US inflation and Dow Jones Industrial Average, 2002-2009



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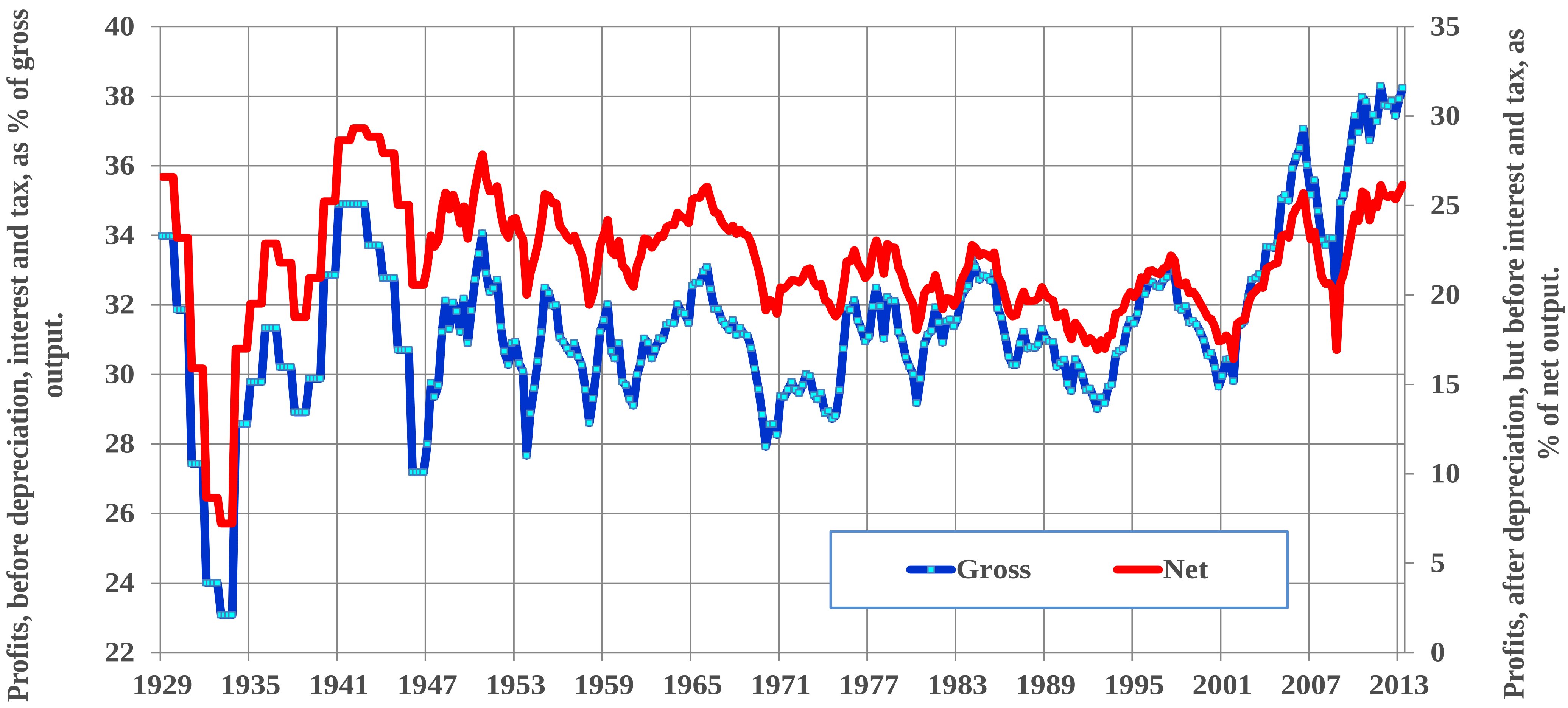
Source: DATASTREAM

Slide 63. US Profit Margins 1929 - Q2 2013.



Data Source: NIPA Table 1.14.

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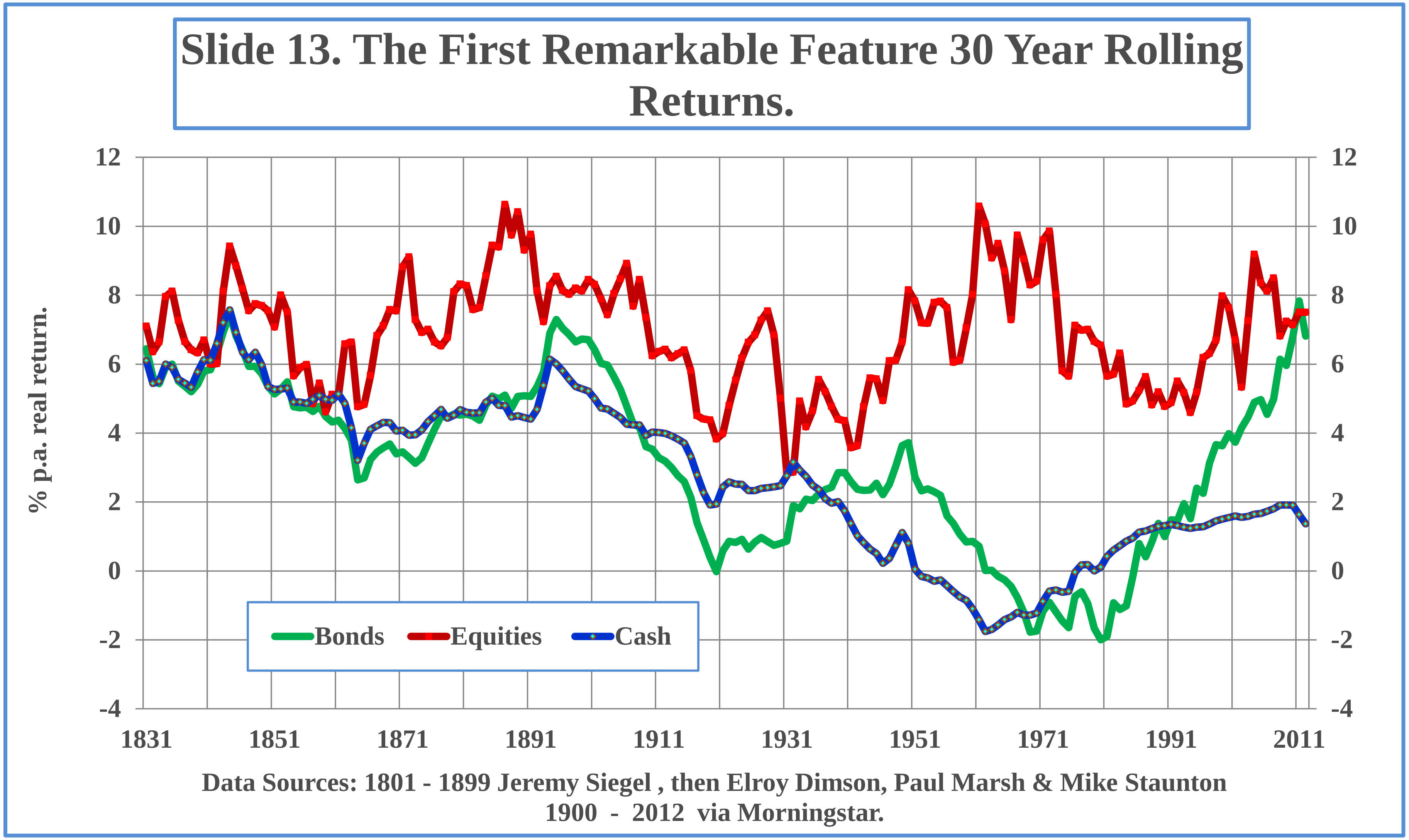
Stability of long term return from equities



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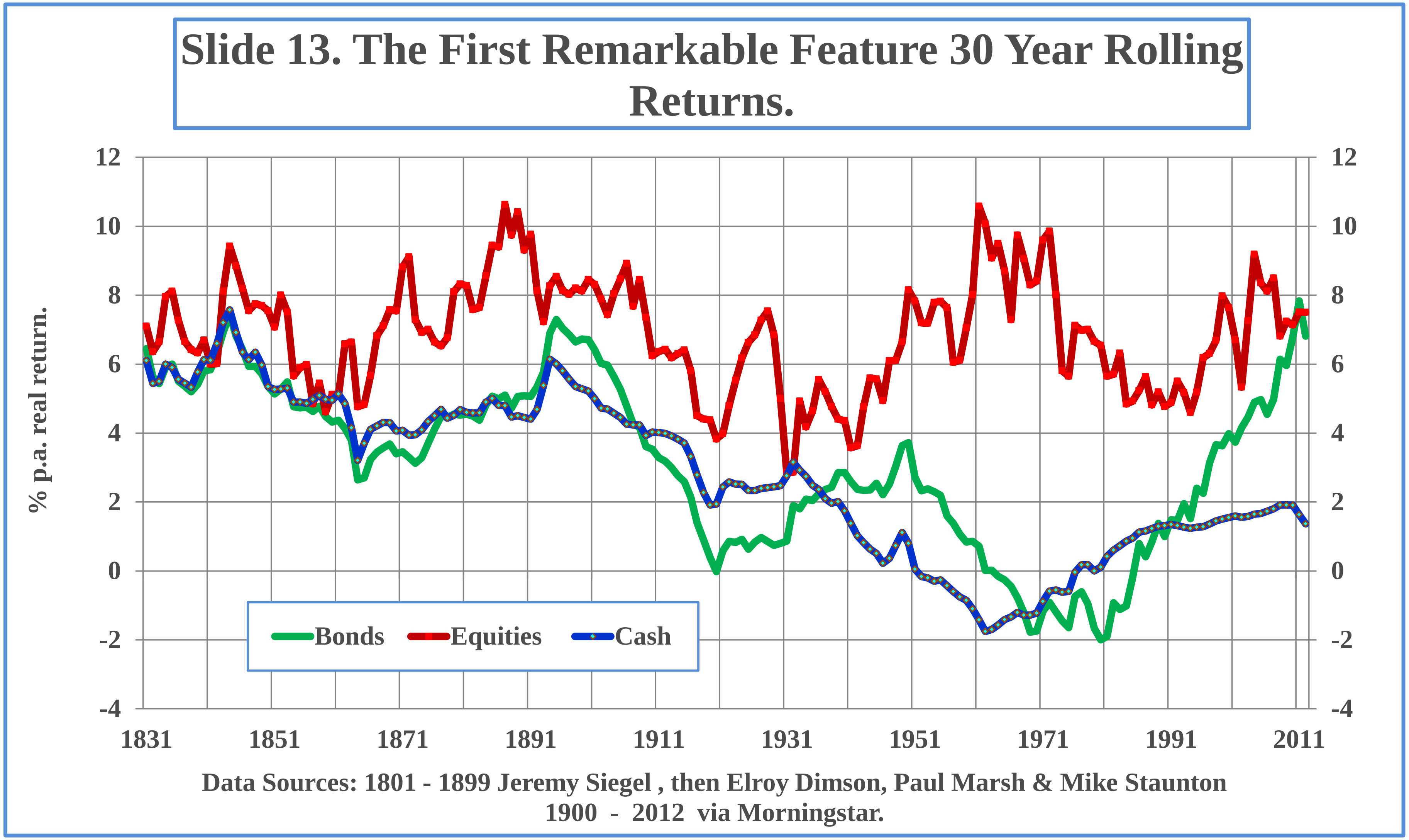
Stability of long term return from equities



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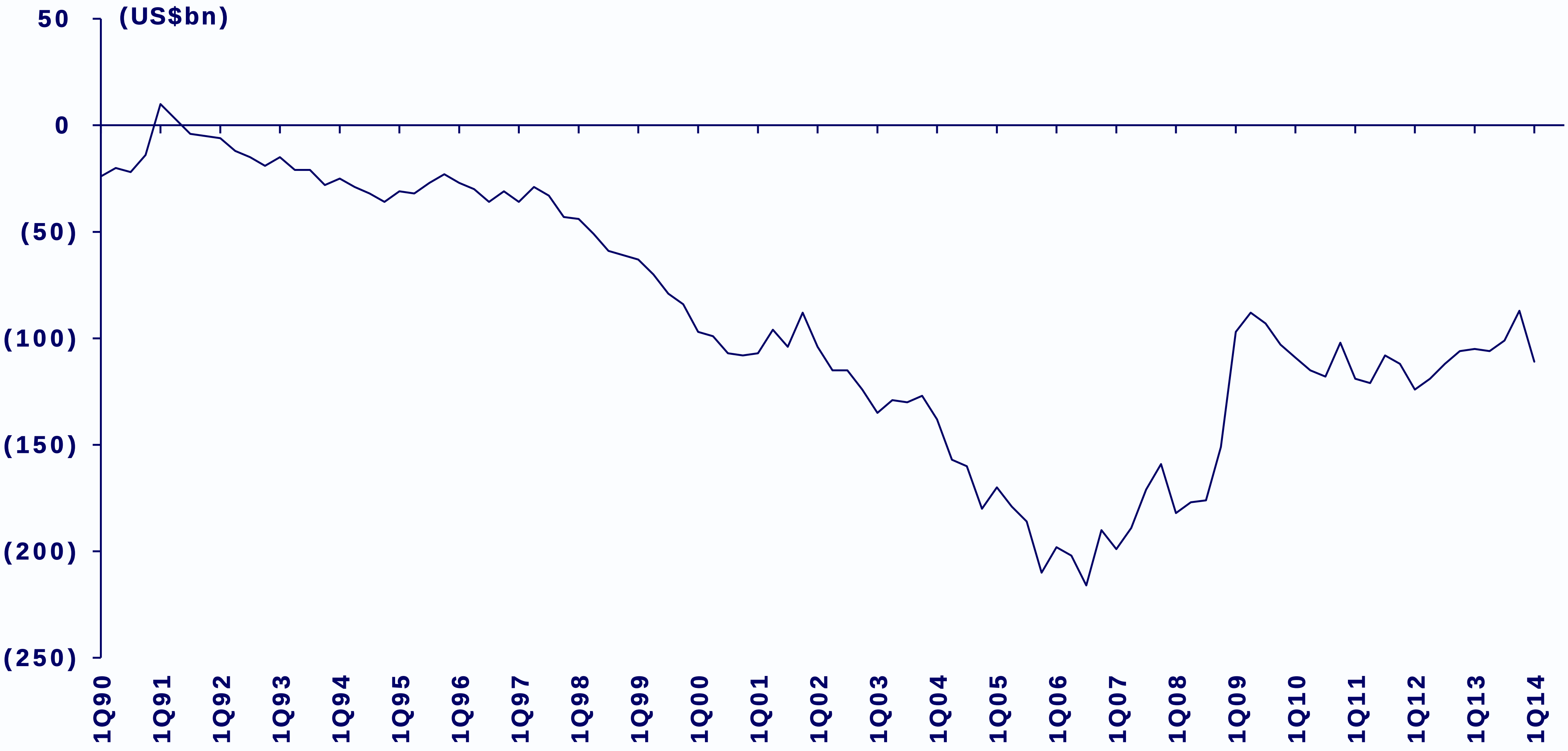
Deflation in the age of QE

- ‘Inflation is always and everywhere a monetary phenomenon’- Friedman
- We do not live in a fiat system as so many countries manage/fix their currencies to others
- For EM’s external surpluses dictate monetary policy
- In fiat systems money is created by commercial banks and not by central banks
- Demographic trends mitigate against credit and money creation by central banks

Smaller US deficits and EM deflation

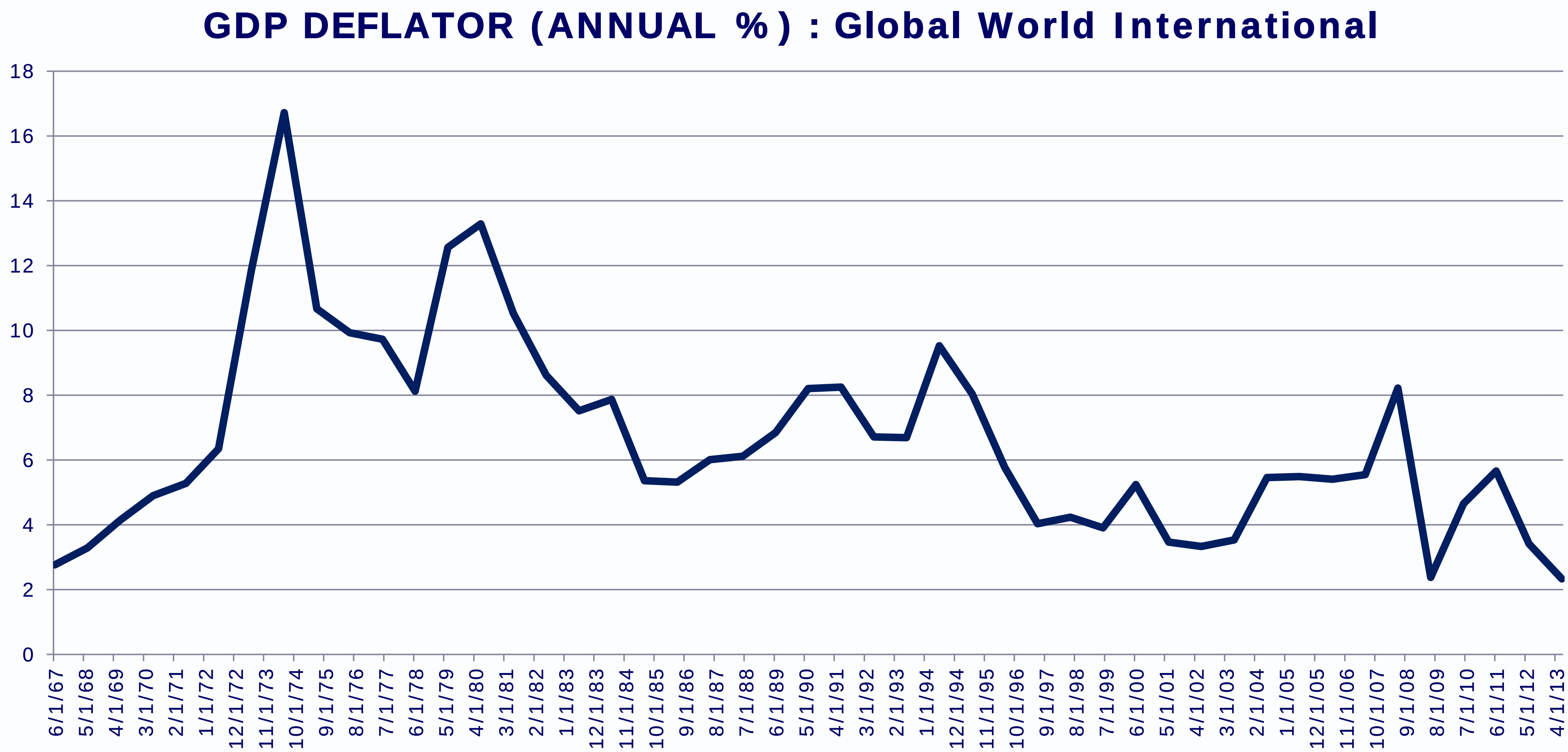
- For almost two decades a widening US current account deficit was the basis for Bretton Woods II
- Earned surpluses allowed liquidity creation and stable exchange rates in EMs
- Since 2009, EMs have borrowed surpluses they did not earn
- The round trip of capital creates liquidity in EMs
- A country with insufficient surplus and liquidity can deflate or devalue and China is particularly vulnerable

US current-account deficit



Source: Datastream

When does 'money printing' begin?



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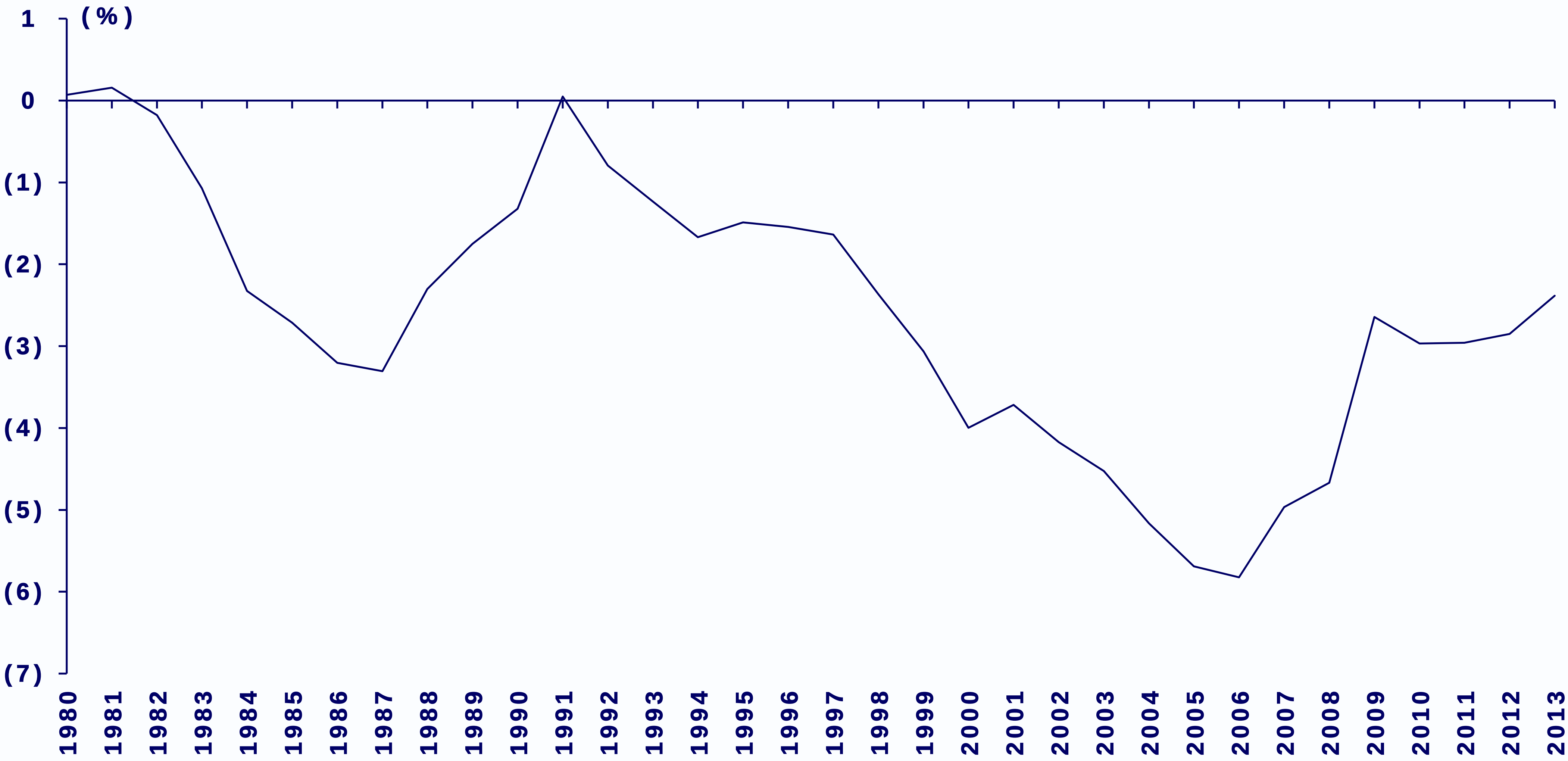
US current-account deficit as % of GDP - A new era

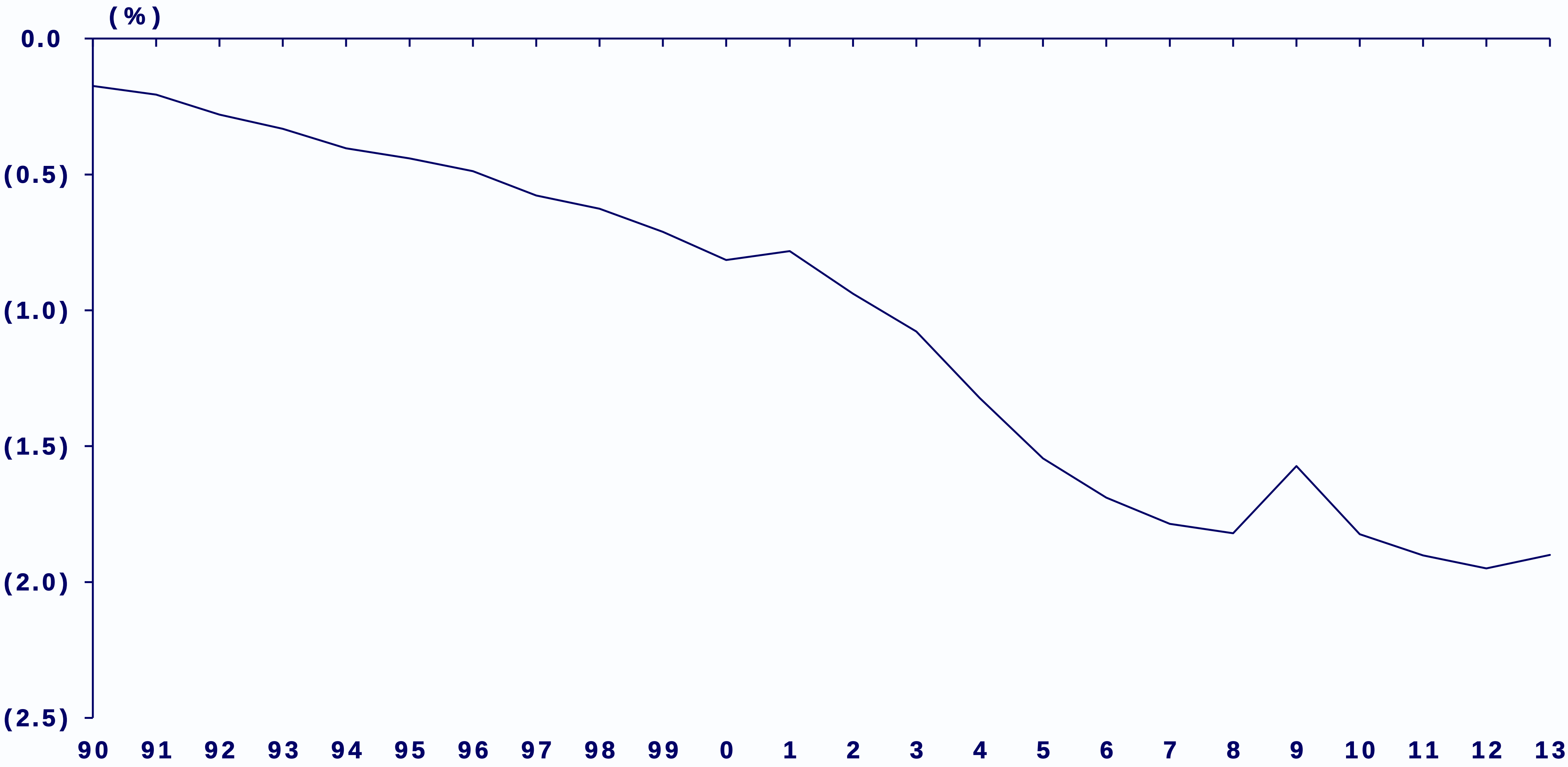


Source: Datastream

The shrinkage in the deficit is structural

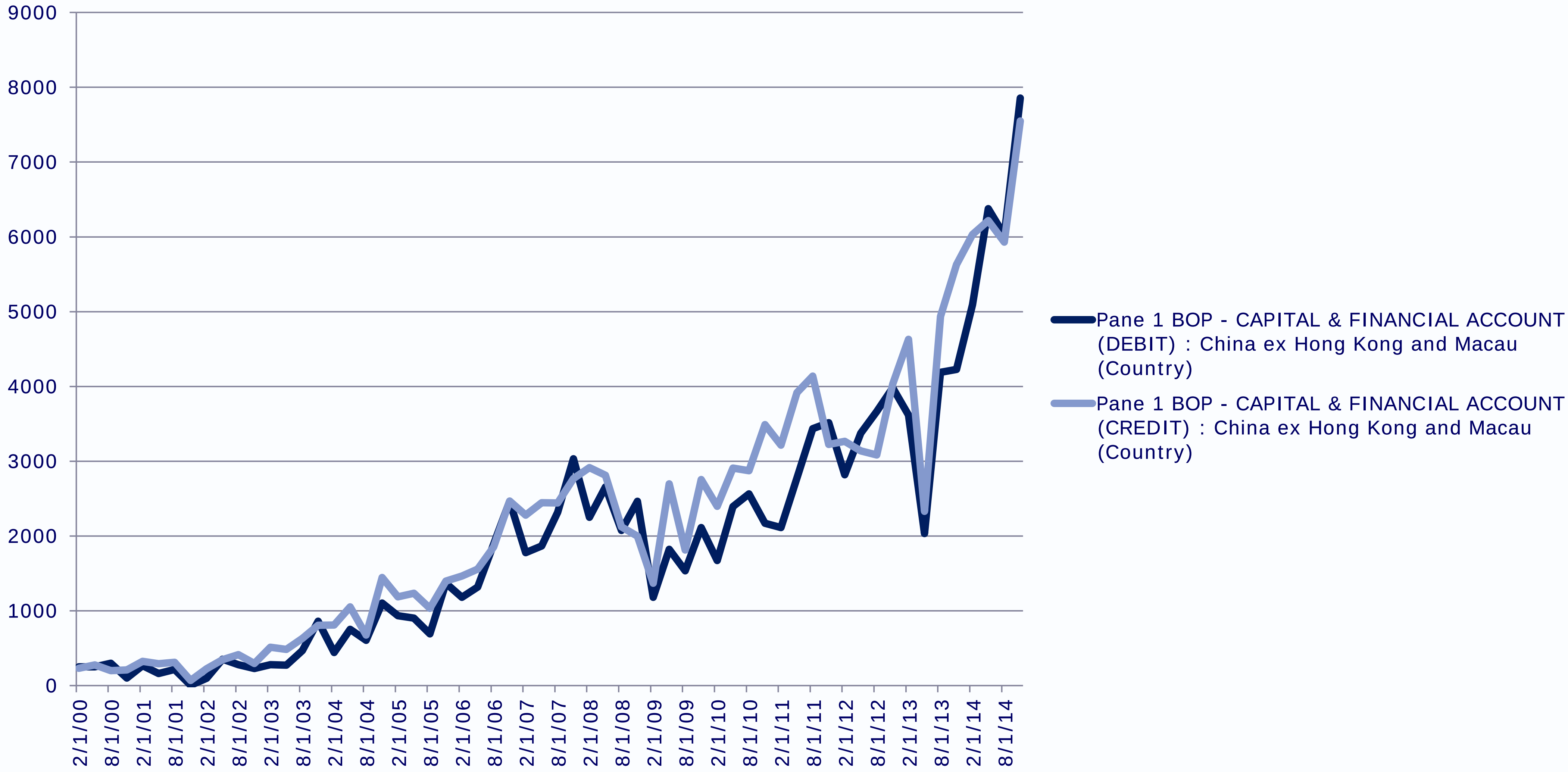
- The shale oil and gas revolution means fewer US dollars in the hands of foreigners
- Chinese manufacturing wages have risen 3x since end-2007 in US$ terms, US hourly wages just 12%
- The baby-boom generation is degearing and saving; and this means less consumption and fewer imports
- If the US is to run structurally smaller deficits. then Bretton Woods II is unfit for purpose
- EMs will deflate or devalue; either will bring a global deflation

US visible trade deficit with China (% of GDP) - Shrinking



Source: Datastream

China's capital inflows and outflows (US$bn)



Source: Thomson Reuters Datastream

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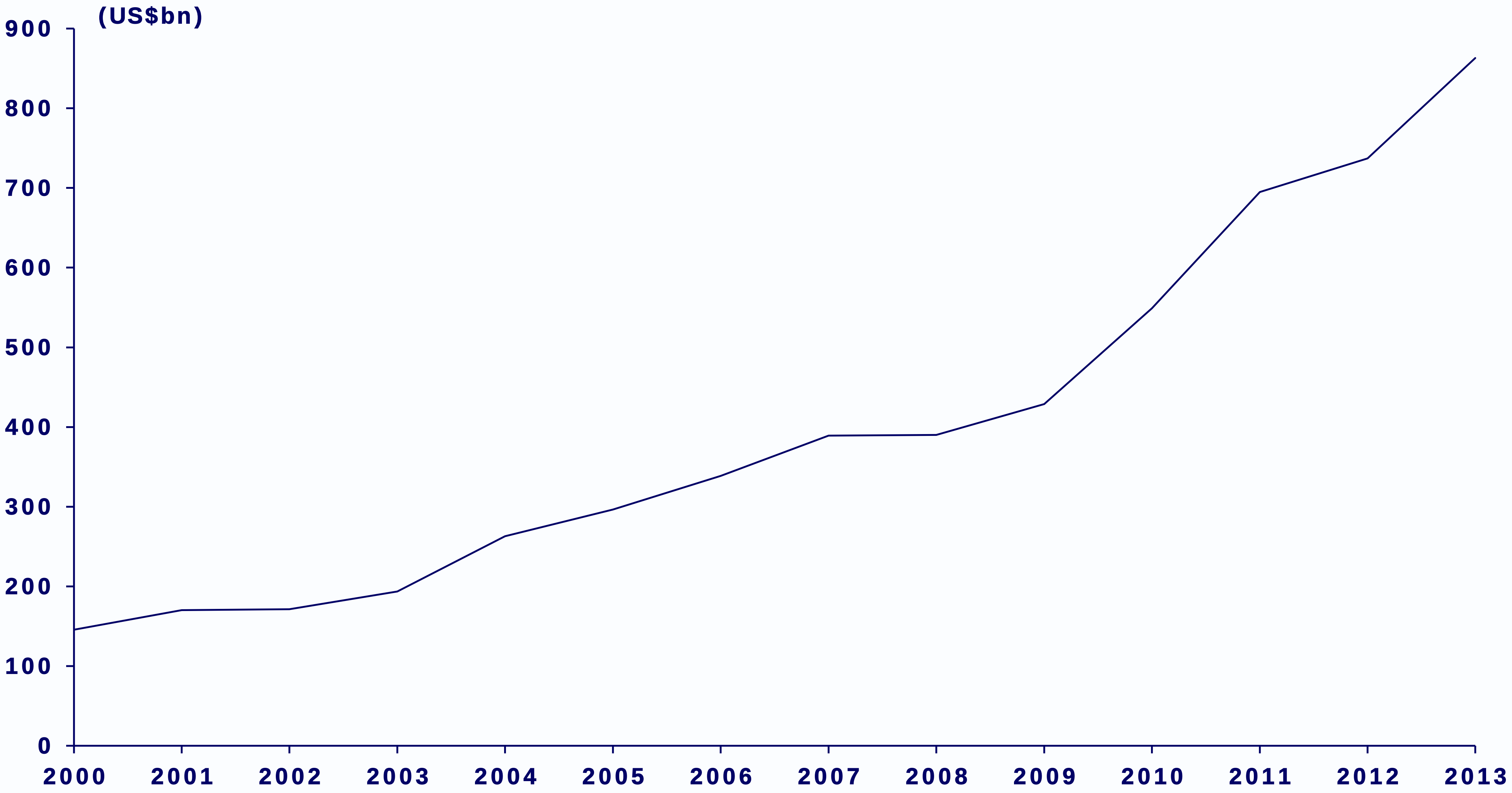
China's gross external indebtedness



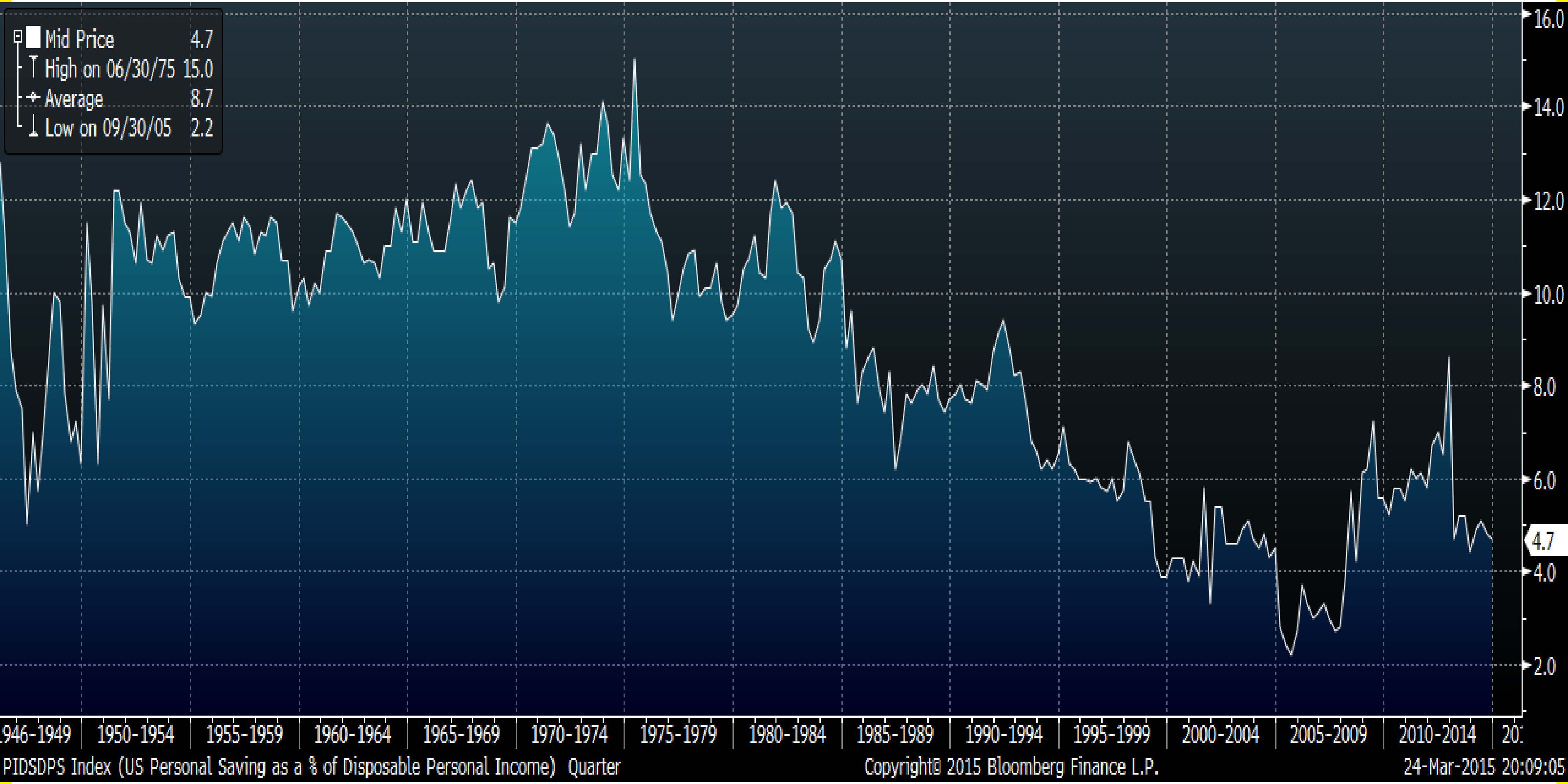
Source: Thomson Reuters Datastream

Family holdings of debt by age of head, 2007 and 2010 surveys

Family characteristic	Secured by resi property: Primary residence	Secured by resi property: Other	Instalment loans	Credit-card balances	Credit lines not secured by resi property	Other	Any debt
Age of head (years)							
Less than 35	37.3	3.3	65.2	48.5	2.1	5.9	83.6
35-44	59.5	6.5	56.2	51.7	2.2	7.5	86.2
45-54	65.5	8.0	51.9	53.6	1.9	9.8	86.8
55-64	55.3	7.8	44.6	49.9	1.2	8.7	81.8
65-74	42.9	5.0	26.1	37.0	1.5	4.4	65.5
75 or more	13.9	0.6	7.0	18.8	-	1.3	31.4

Source: Federal Reserve Survey of Consumer Finances

US personal savings as a % of disposable income



Source: Datastream

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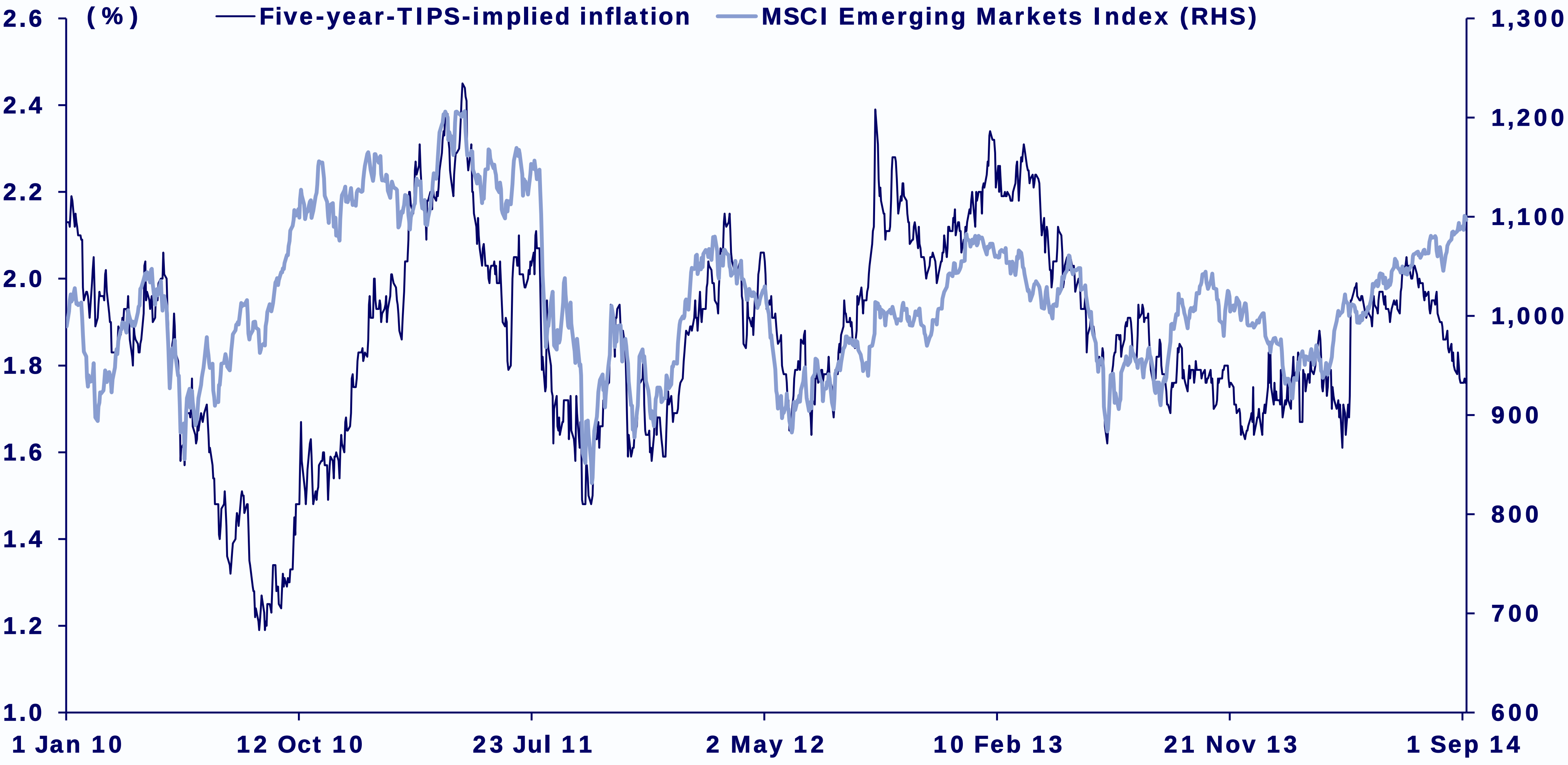
Five-year-TIPS-implied inflation versus MSCI EM Index (US$)



Source: Datastream

Gross External Debt Table

Gross External Indebtedness 3Q 2014
(US$bn)

Source: Joint External Debt Hub and World Bank

Argentina	148	28%	**Macedonia**	7	73%
Belarus	41	53%	**Mexico**	419	32%
Brazil	540	24%	**Mongolia**	19	158%
Bulgaria	49	90%	Pakistan	56	24%
China	874	8%	Peru	61	29%
Chile	137	52%	Phillipines	58	20%
Columbia	98	25%	**Poland**	370	67%
Croatia	58	100%	**Romania**	120	59%
Czech Republic	127	64%	**Russia***	679	33%
Ecuador	19	19%	**Serbia**	36	80%
Georgia	13	81%	**South Africa**	142	42%
Hungary	190	147%	**Thailand**	143	38%
India	456	22%	**Turkey**	397	49%
Indonesia	292	22%	**Ukraine**	136	101%
Kazakshtan*	155	34%	**Uruguay**	24	44%
Korea	429	28%	Venezula	119	27%
Malaysia	213	68%			

* exchange rate movements since end September 2014 will have pushed external debt to GDP ratios well about 35%

Conclusions

- The size of the US current account deficit is a key driver of global liquidity but it is not growing
- Structural reasons - shale oil and gas, rising Chinese wages, baby boom degearing - stop the deficit growing
- The de-gearing of the baby boom generation restricts the effectiveness of monetary policy
- EMs, particularly in Eastern Europe, have borrowed too much in foreign currency.
- Six years after the launch of QE we get deflation anyway and a move to government action