Inflation and the Debt Bomb: Ready to Explode

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Inflation and the Debt Bomb: Ready to Explode

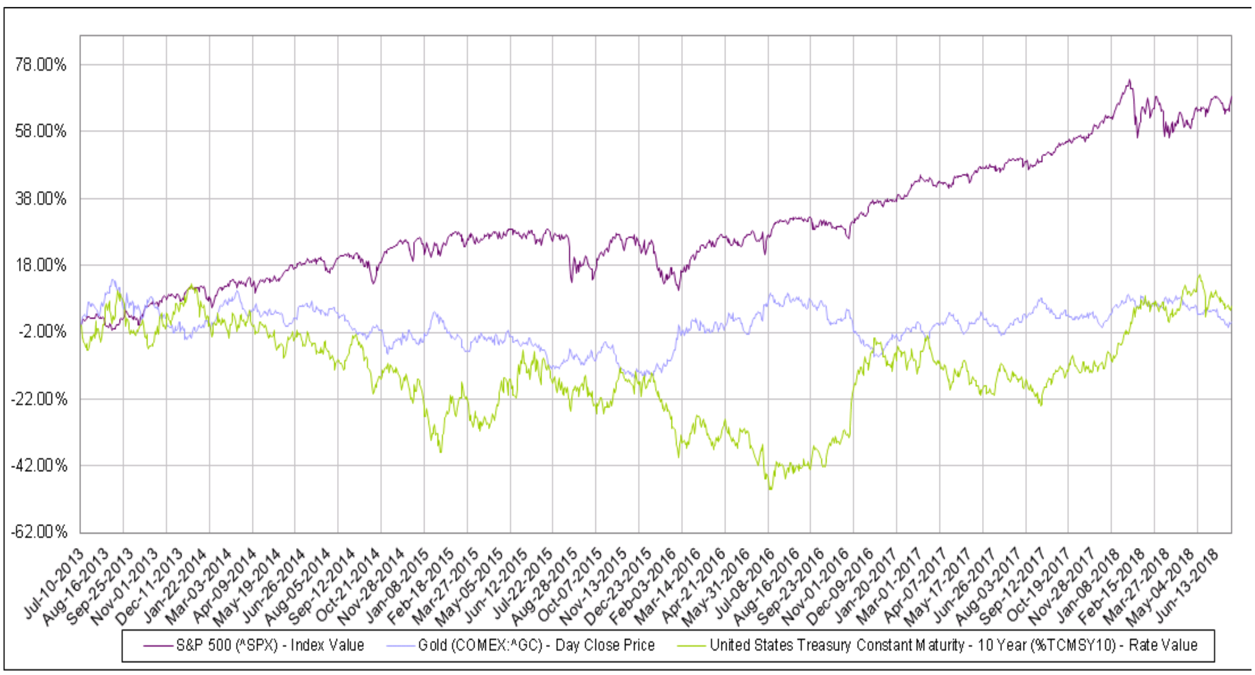
By Jim Pearce (bio at end)
July 12, 2018

A reader recently asked why inflation remains low despite an increase in the global money supply. Considerable cash has been pumped into the economies of Asia, Europe, and the United States by their respective central bankers over the past 10 years. Shouldn't that result in rising inflation, as consumers bid up prices for all the things they like to buy?

That is a good question and gets to the heart of why I think the stock market is over-valued and poised for a tumble. Inflation, combined with the total global debt bomb, constitute a grave threat to investors. Below, I explain how to reposition your portfolio for "defensive growth."

Hidden Inflation

Over the past five years, since the U.S.A. began winding down its massive Quantitative Easing program, the net increase in the price of gold (**light blue**) is a measly 1%. At the same time, the 10-year Treasury note constant maturity index (**green**) has generated a total return of just 6% (see chart below).



If you only looked at those two data points and knew nothing else about the economy, you might reasonably surmise that there has been very little growth in the economy. And you would be correct. During that time, U.S. gross domestic product (GDP) grew at an average annual rate of about 2.5%.

In stark contrast, the S&P 500 Index (**purple**) has gained 68% over the past five years. During that span, the cumulative earnings of all the companies in the index grew by 18%. The difference in those two numbers - fifty percentage points - is huge and points to where inflation has been building while consumer prices remain relatively flat.

Simply put, a large portion of the money pumped into the economy over the past 10 years has been used by publicly-traded companies to repurchase shares of their own stock. That is clearly good news for shareholders of those companies, and the index fund investors that indirectly benefit as well.

(BW: It is my opinion that there are too many inter-related extraneous factors at play in the marketplace to be able to judge convincingly that share buy-backs are beneficial to shareholders in terms of a rising stock price because of those share repurchases.)

Although the net result of repurchasing stock is an increase in the wealth of shareholders, that money does not have an equally-large impact on consumer prices since much of it is saved instead of spent. Because the majority of repurchased shares are held by institutional investors and wealthy individuals, much of that cash may not be spent for a very long time.

The $247 Trillion Debt Bomb

Meanwhile, the Institute of International Finance reported on Tuesday (July 10) that total global debt now stands at $247 trillion. If you think that sounds like a lot of money, it is. By way of comparison, that is more than three times higher than the combined GDP of every country in the world.

With so much money tied up in stock, there is not enough capital available to consumers, companies, and governments to finance their spending. They borrow instead. As more borrowers accumulate debt at an accelerating rate, inflation (and a corresponding recession) cannot be far behind.

That is why I believe many stocks are over-valued. Even if the U.S. economy can somehow ramp up its growth rate to 3%, that is not high enough to justify the earnings multiples for most growth stocks. There will not be enough cash flow generated to maintain the same rate of share repurchases over the next five years as the past five, because much of that money will be needed to service all that mounting debt.

For the same reason, I feel low-multiple value stocks will be better able to hold their value in the inflationary environment that is almost certainly coming. If you fear you may have too much of your wealth tied up in the type of companies most at risk of inflation, now would be a good time to start repositioning some of that money into financial assets that can thrive in a rising rate environment.

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About the Analyst

Jim Pearce
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Jim Pearce is the Chief Investment Strategist of *Personal Finance*, our flagship publication. He is also the Director of Research at Investing Daily, overseeing the work of our entire analyst team. He began his career as a stockbroker in 1983 and over the years has managed client investment portfolios for major banks, brokerage firms and investment advisors. Jim has a BA in Business Management from The College of William & Mary, and a CFP from the College for Financial Planning.