

Navigating Economic Uncertainty

Uncharted Waters

With the global economy having apparently emerged from the free-fall phase experienced between October and February, investors – including many Oarsman Capital clients – are rightly beginning to wonder how to navigate the uncharted waters ahead. The most commonly voiced concern centers around the notion that the unprecedented monetary and fiscal stimulus unleashed over the past year will inevitably lead to a damaging rise in inflation. At the same time, a not-small percentage of economists and market strategists fret that even the massive stimulus provided to date will prove insufficient to keep the economy from receding back into a prolonged “W-” or “L-shaped” slump that, if anything, could rekindle an even more pernicious bout of deflation.

Our Read

We believe the threat of inflation is both widely acknowledged and probably exaggerated over the next year or two (at least), while the lingering risk of deflation is probably under-appreciated, even if relatively small. However, one recipe for investment disaster that we always try to avoid is to make a “bet” on the economy and get it wrong. Accordingly, we think it makes sense to position client portfolios to ride out either outcome.

Preparing for Inflation:

As noted, we are not in the camp that believes roaring inflation is on our doorstep. In fact, the current slack in the economy (think: 9%+ unemployment; record-low factory utilization) suggests we have a long way to go before inflation rears. However, a depreciating U.S. currency and spiking commodity prices could stoke inflation *fears* in coming months (and fear can be as damaging to markets as the thing itself). What investments should do (relatively) well in an inflationary/inflation-fearing environment?

- TIPS (inflation-indexed Treasury notes; yield goes up with inflation)
- Inverse bond-market funds (gain value if yields rise)
- Short-term bonds
- Commodity-related investments (including gold- the classic inflation hedge)
- Non-US investments (do better when U.S. currency falls)

Preparing for Deflation:

While we believe that the stimulus in the pipeline combined with the natural resilience of the U.S. economy make the likelihood of deflation small, its effects would be sufficiently unpleasant to be worth preparing for. In many regards, a deflationary environment calls for a more defensive portfolio posture:

- Long-term bonds (of the highest quality)
- CDs (government-insured)
- Inverse stock-market funds (gain value if stocks fall)
- Gold (for the Armageddon scenario where no one wants stocks OR bonds)