How to invest during the Great Unwind

These are scary times, but it's not all doom and gloom, Paul Hodges tells our editor-in-chief

The last time I met with Paul Hodges, chairman of International eChem (IeC) and an expert on the economic impact of demographics, he told me that deflation was coming; that we should all buy more gilts; and that if you held shares in Tesco you should dump them. He was right on all those things. Last year he sent me a report he wrote saying the oil price was about to plummet. He saw it falling to $50 a barrel in the first half of this year. That, clearly, has happened already. Given this record of rightness, I asked Hodges back to the MoneyWeek sofa (we've started recording our interviews here -watch this one online at moneyweek.com).

The Great Unwind

So how is it that his crystal ball works so much better than everyone else's? It is, he says, all about understanding the "great unwinding of policymaker stimulus". Extreme monetary policy has given us a "sugar high", with all markets going up in a straight line -and in the commodity markets at least, this is being justified by the apparent rapid growth in China. But what Hodges, who "used to work with President Xi's father in days gone by", spotted, was that China was going to slow much faster than most people expected. That's because Xi never intended "to continue with the policies of the previous government". He is not interested in endless monetary stimulus creating bubbles and property wealth effects. Instead, he wants to create rising incomes. That is giving us a "new normal" – one that involves old bubbles bursting.

Evidence of Chinese growth slowing fast? It's everywhere, says Hodges. Look at property taxes: the take was down 30% last year. And car sales. The "only growth has only been in China" in the last few years, but now the dealers are arguing with companies such as BMW – demanding cash payments to stay afloat because they can't sell their inventories.

The key to Hodges' thinking is that, as he understands it, all the growth of the last few years has been artificial. The "new normal" is based on the fact that the recent rise in life expectancy and fall in the birth rate have left us with rapidly ageing populations. "The corollary... is that people over the age of 55 already have everything they need... they're moving into a world where their needs and also their incomes are going down... so you cannot get growth. It's a very simple argument; it seems to be very obvious to me." Post-war, there was huge catch-up demand. Then from 1983 onwards the baby boomers "began to get jobs, and we began to earn some money... our demand was very steady because there were so many of us, but also we were creating supply, and we had a period of disinflation". Now we still have plenty of supply "left over from when we were consuming like mad, but we don't have the demand any more".

The oil-price charade

So the oil price at $100 was not a function of real demand, but of credit-driven demand. It was a "charade", says Hodges. "There has never been, since 2009, a single moment anywhere in the world where there was a physical supply shortage." Instead, the price rise was due to "every pension fund in the world" knowing that the Federal Reserve wanted to devalue the dollar. They looked for a store of value to protect themselves. "That, of course, was oil... it's a large market, and it's priced in dollars... suddenly you've got financial players going into the market. What happens? Of course, the price rises and goes from $30 at the end of 2008 up to $120, because you can't print oil in the way that you print money."

> "Evidence of Chinese growth slowing fast? It's everywhere"

Ambitious new rail links signal an

And the move down from $120? Most people assume it's about the Fed tapering, says Hodges. But they are being too "Fed-centric" in their thinking. It's actually about China stopping its stimulus programme. "Once you start deflating a bubble, it doesn't go slowly; it bursts. This is what you saw happening in July and August... that's why in the middle of August (2014) we said, 'the oil price is now going to collapse, and the obvious logical corollary of that is the dollar is going to go very high indeed'... we've now seen that." The rising dollar might not seem that big a deal to people thinking in pounds. But, says Hodges, it is if you look at the $6trn-$7trn of debt in the emerging economies all tied to the dollar.

When they borrowed dollars at 1%, it looked clever. But as the dollar rises so does the value of their debt. Not so clever. "You're going to see bankruptcies all over the emerging economies." I wonder if we'll see significant bankruptcies in the US too, due to overspending in the energy sector. We will. "The US economy is now riding for a fall. If you look at net jobs growth since 2009, it's all -and I mean all – been tied into the oil and gas exploration bubble." The same goes for the housing recovery. "Most of that new house building has been in Texas in the oil belt." Demand for that oil is just falling away.

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Important change of direction for China

China is the key

So all is lost? No. There are "some very sensible policies about future growth going on. President Xi and Premier Li are moving forward on what they call the 'New Silk Road'." China is worried about employment and income levels.
So Xi is looking to boost the economy with, for example, ambitious railway links all the way from China to Europe.
He wants to build for the future: to "recreate the position of China as the Middle Kingdom ... we don't know, of course, whether it will work, but it's far better than building empty skyscrapers". All this makes "China the place to watch". As long as China doesn't change policy, "which I think is very, very unlikely", this "great unwinding will continue and the Fed will end up being surprised to find that actually its US recovery has disappeared". That matters, because there isn't much else keeping the global economy afloat. Russia and some of the countries in the Opec oil cartel are "in major economic crisis". We're also "looking at a return of the eurozone debt crisis and Greece", to say nothing of "mounting political risk here in the UK".

I start to worry. Hodges appears to be even more depressed about the global economy than the average MoneyWeek writer – and you don't see that much.

I wonder if he can see any good news in his demographic deflation disaster scenario. He can: "I'm actually quite happy, because I believe that we are now going to have to confront the issues that we should have confronted ten and 15 years ago." That we all live 20 years longer than we used to is a "wonderful bonus". So "why have we got a lower pension age than 100 years ago, when Lloyd George brought it in? Why are some countries actually reducing the pension age... you cannot run an economy where nearly one in two adults is over the age of 55 as if it was full of children ... it's ridiculous."

Sell gilts and houses - hold cash

I try to stick with the good news by moving on to investment. The last time I interviewed Paul, back in 2013, he told us that gilts were the best thing for retail investors to buy. That was a good call. So is he still holding them in his own portfolio? He is not. Why? The debt burden in the UK is now so huge that the public finances simply can't cope with deflation. He is, as a result, genuinely concerned about the UK defaulting on its debt – default is not his base case, but the risk is high enough that he has "sold the lot".

Tesco? Hodges hated it two years ago because he felt that -just like central banks and governments – its then-boss, Philip Clarke, was "trying to pretend that we still have the population and the demand levels of five and ten years ago... so he was building more and more hypermarkets". Now Tesco is heading back in the right direction. Big stores are being shut and more staff are going int0 the remaining stores. This makes sense: when you're older, you want to be able to go down to your local store, "have a chat... buy what you need for that day... so shops need fewer automatic tills and more people" . This is to be another part of the great unwinding – "companies are going to have to go back, not to stripping out costs, but to focusing on what their customer actually wants". I ask what the great unwind will mean for house prices. "We've seen price falls in the housing market in the past in the early 1990s and they went down 50%, and I think that we're at the start of that kind of decline now -as I think, indeed, fairly soon we will be at the start of that in the stockmarket as well... it's just something we have to go through to get to reality."

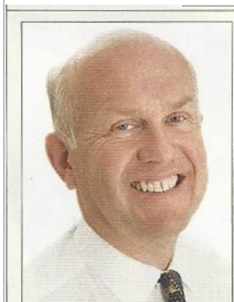
I wonder. Is it really possible for deflation to prevail -in an environment in which central bankers can (and do) print as much money as they fancy? That depends, says Hodges, on just how far the central banks are prepared to go with their

"Cash is a very good investment under deflation"

"outdated theories". Milton Friedman "told us that inflation was always and everywhere a monetary phenomenon... but he was wrong... completely wrong". He worked during the baby boom in the US. Massive demand, low supply. "Of course there was inflation" and of course interest rates, by curbing demand, could hold it back. But if there isn't demand, you can't create it.

Evidence? The central banks have been trying to create it for six years. They've failed. So unless they go nuts (which is possible), print until confidence is gone and we get hyperinflation, deflation it is. What does this mean for investors? I ask. It sounds like we shouldn't invest in equities, in property, or in commodities. "No." What then? "Cash is a very good investment under deflation," says Paul: "its value goes up every day."

Who is Paul Hodges?



Paul Hodges is the founder and chairman of International eChem (IeC), which provides advice on strategy to the chemical industry and investors in the sector. IeC's clients include many of the world's major companies and investors. He is the co-author (with John Richardson) of the ebook *Boom, Gloom and the New Normal,* which describes how demographic changes are taking chemical demand patterns in new directions. He also writes the ICIS 'Chemicals and the Economy' blog (www.icis.com/blogs/chemicals-and-the-economy). where he forewarned of the current financial crisis.