

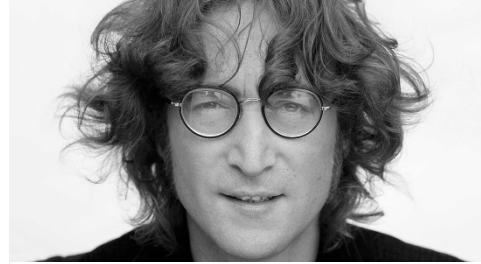
Imagine No Inflation

Many folks have now listened to this fascinating interview of the pseudonymous Jesse Livermore by Patrick O'Shaughnessy; which can be found here: <http://investorfieldguide.com/livermore/>.

Jesse has some extremely novel perspectives, but you'll have to slow things down to 0.2x, because he spits economic bars faster than the guy in the FedEx commercial.¹

Jesse's most intriguing supposition is that inflation and interest rates will stay low forever. Yes, forever.

He acknowledges that the "it's different this time" statement is – in his words – a dangerous and almost fraudulent claim, but he breaks it all down nicely. He argues compellingly that the reason we demand anything in return for our money from banks (in the form of interest) is because of a fear that we might not be repaid. He then asserts that with the evolving mandate of the Federal Bank, now all but solidified by their post-2008 behaviour, we now



Really?

know we are going to pretty much get our money back in any event, almost no matter what, so we don't need to be offered much in the way of a return in order to part with our cash, and that keeps things pretty stable.

Of course he is talking about receiving nominal dollars back, not real dollars, but this leads to his second big assertion; he also claims that inflation will be low forever. At this point of the interview, Jesse was flying, so I might have missed his full explanation; but I suspect it is based on a view that an increasingly-politicized fed will keep a lid on things (or that we believe they will) – perhaps alongside continuously increasing technological innovation – and that as developed economies become demographically mature, this may perhaps impact price anchoring and inflation expectations.

His final, major point, which is somewhat related to the inflation point above, is that accounting rules in the US (in fact, globally) understate the cost of maintaining assets. In other words, true "depreciation" (which is supposed to mimic or represent the cost of maintaining or replacing assets) is higher than what is reported in the P&L. P&L depreciation is based on the book value of an asset, an asset that may have been purchased long ago, which itself has a much higher replacement value today.

He believes this thus renders trailing (or indeed) forward P/E ratios incomparable over time, and may perhaps imply that the P/E ratios of what appear to be optically cheap companies may in fact be much higher, because the "real" earnings after a fuller depreciation are much lower. He naturally has a similarly negative view on ROE based analyses.

I see his point, technically, but disagree with the motivation. His framework seems broadly based on a one-off asset purchase, not as a serial, continuous process of maintenance and expansion capex, which is what happens IRL. As the new CAPEX comes in to keep the plant up-to-date, or indeed build a new one, this happens *after* the inflation has occurred, and automatically increases future depreciation, bringing it more in line with the true economic cost of ownership. To me, this all should come out at the end when we look at free cash flows (which consider the CAPEX). And in that vein, Jesse himself concludes that we need to look beyond the P&L to the "true distributable free cash flows that the companies are generating." Fair enough.

Finally, Jesse brought a different perspective to the momentum and value discussion, and appeared to do so without any academic baggage (good or bad) regarding empirical evidence over typical overreaction or underreaction time horizons, nor the risk or behavioural explanations of either.

So, I guess, in conclusion, I disagree that interest rates will stay low forever, I disagree that inflation has been eradicated, and I disagree that the market misses the understated impact of depreciation. But man, I sure enjoyed the interview. I couldn't stop listening. Jesse is very engaging, and Patrick is a very good interviewer. If you haven't already, it is definitely worth a listen.

¹ <https://www.youtube.com/watch?v=Nek5ZitpO-M>

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