

Thought for the Week: Monday, June 7th, 2010

Inflation or Deflation...where Next?

The future direction of both Stocks and Bonds will depend to a great degree on the following question:

Is America entering a period of Inflation or Deflation?

The ideal outcome of the current financial situation would be for our Government to pull-off a Utopian exit from extremely low interest rates called a soft landing, or what we sometimes call the Goldilocks Scenario, where interest rates become neither too hot nor too cold.

Although our recent management strategy has been to prepare our portfolios for Inflation, recent signals, such as the government declarations of forthcoming austerity across most developed countries and fiscal tightening in Emerging Markets, have brought the prospect of Deflation into view.



Inflation

The current balance of opinion is that all the **stimulus dollars being pumped into the economy have 'Inflated' the supply of money** which historically leads to reductions in the value of the 'dollar in your pocket'. If the 'dollar in your pocket' is worth less, it buys less which means the real cost of goods has increased. This is Inflation.

A little inflation is a good thing and most governments set inflation targets in the 2% - 3% range. **The Positive Effects of 'controlled inflation'** include:

- **Reduction in the Real Cost of Borrowing:** If the numerical value of the money you receive rises but your interest payments remain fixed, the loan just got cheaper. Think of government debt. If GDP rises by the rate of inflation but the debt remains the same, the Debt to GDP ratio will fall.
- **Business Stimulus:** When prices rise those companies that receive increased revenues may not have to raise their costs immediately, therefore their profits increase. Moreover, if inflation is high, the attraction of 'safe' low interest rate investments such as Money Markets declines. This money may start to chase higher 'inflation-plus' returns by investing in real assets such as companies and projects. This is now known as the Tobin Effect.

As with many concepts, there are limits. **If Inflation climbs too high, it becomes 'Noticeable'** by consumers, savers, employees etc and everyone starts to increase prices, interest rates and demands for wage increases. This leads to uncertainty; savers and investors alike become confused and start to hoard capital in assets which do not benefit the economy, such as Gold. Moreover, rises in producer prices make **exports less competitive and imports more affordable.**

Deflation

To many, **Deflation is worse than Inflation**, because it is harder to control and its effects are much more damaging to the economy.

Although you would think that people would be delighted to see prices fall, if this price reduction continues for an extended period companies' **profits begin to decline.** Economic conditions force companies to sell their products for even cheaper and subsequently cut back on production costs, reduce employee wages, lay off workers or even close production facilities. At this point, **unemployment will increase, the economy cannot expand** and people stop spending their money because their economic future seems uncertain.

Equity prices begin to decline as people sell off their investments, which are no longer offering good returns, and bonds temporarily become more attractive.

Why Worry?

The Supply & Demand Economics of Consumer Psychology/Spending have a great deal to do with Inflation & Deflation. **If consumers feel like spending, demand increases and prices can rise.** If the same people feel frugal, companies have to reduce prices to maintain sales and deflation occurs.

Therefore, **to control Inflation**, governments can reduce spending to make people feel poorer and raise interest rates to encourage saving. This curtails excessive supply and reduces demand for good, thereby restraining companies in their attempts to increase prices.

So, at the first signs of inflationary concern, the Government might raise interest rates and cut spending. They have just started cutting spending but have yet to commit to interest rate rises.

Bottom Line: If Inflation appears, the Government has a locker full of ammunition to fight it.

Conversely, **governments control Deflation** by reducing interest rates to discourage saving and increasing spending to make people feel wealthier.

Unfortunately, Interest Rates are about as low as they can go and government spending is about as high as it can go. Ergo, the U.S. Government has done as much as it can to deflate prices.

**Bottom Line: The Government currently has very few ways to prevent Deflation.
That's a Worry! This is what Fed is worried about now.**

Deflation Case Study: Japan

Proponents of Deflation as the next step for America cite the case of Japan over the last fifteen years or so. During this period, the Japanese economy has experienced periods of Deflation, initially resulting from:

- **Falling Asset Prices:** The popping of large Equity and Real Estate price bubbles throughout the 1980s caused Japanese money supply to shrink, which is deflationary.
- **Insolvent Banks:** Banks have a large percentage of "non-performing" loans, that is to say, they are not receiving payments on them. Unfortunately, they were slow to write the loans off which means the capital is "non-performing" and not contributing to economic stimulus. This is deflationary.
- **Currency Strength:** Maintaining a strong Yen lowered the price of imports, exacerbating price Deflation.

Does this remind you of what's been happening in our own country?

Is the U.S. economy experiencing Deflation as we speak?

Absolutely! The cautious psychology of the consumer and the lack of demand in the supply/demand balance are making suppliers cut prices to move product. It's only the **Government's excessive spending, and the reduction in production capacity by companies, which has prevented significant price Deflation.**

So why are we still preparing for Inflation above Deflation?

Let's use the Japanese example to state: **This ain't Japan!**

- Japanese policy was a massive contributor to their prolonged Deflation. **Japan swept their problems under the rug** and paid the price.
- In the **U.S. market forces are far more persuasive and the Government is more open** – Seriously!
- Employment was kept high in Japan leading to wage cuts which deflated the entire economy. In the U.S. we are seeing unemployment devastate those it touches and those areas where it's concentrated. Meanwhile, **those in employment retain much of their spending power.**
- Moreover, the **U.S. consumer finds it much harder to save** than their Japanese counterparts. Spending is Inflationary; Saving is Deflationary.

How has the recent issues affected our Portfolios?

- Approximately nine months ago, we began **reducing the sensitivity of our bond investments** to interest rate rises. If and when interest rates rise, expect Bond values to fall.
- Additionally, we invested in Treasury Inflation-Protected Securities (TIPS) as a **hedge against inflation.** Although these moves were beneficial, inflation hasn't appeared yet and we have recently given back some of our earlier gains.
- We have also invested in assets that provide **income without interest rate sensitivity**, for example Senior Loans and Floating Rate Loans. These areas have recently suffered from the Euro contagion and general market negativity but are still paying their attractive yields.
- We allocated a small percentage of our more conservative portfolios to **growth sensitive asset classes that pay attractive dividends.** This policy has yet to reward us.



If the current phase of negativity continues, we may look to realign the portfolios but much of what is happening is sheer over reaction.

Our main thesis is Two-thirds of the world's population is inflating...and this will drive commodities and company growth. **Consensus suggests Global growth of 3% - 4% next year.** That isn't a deflationary statistic.

Just like the picture on page 1, we feel **this growth potential will ultimately outweigh the drama unfolding in Europe.**