"Deflation"- the dirty little secret

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April 1st 2009

The malls are empty, new homes sit vacant, commodity prices are down, and unemployment is up. Many people are asking: is this inflation or deflation? This topic has been debated quite a bit recently but no one has come up with a clear answer

With the S&P500 down more than 50%[1] from its peak of 1,576 on October 11, 2007, the index will have to increase 100+% to get back to that high point. This is not easily done, even if the economy starts to show signs of recovery. As bad as this is for investors, the scenario is much worse if the stock market does not rebound for many years, changing the dynamics of many investors' plans for retirement. This is especially true for baby boomers who are approaching retirement.

Japan has been in a 19-year bear market since the start of the Nikkei's decline in January 1990[2]. If the U.S. has a similar reaction to our current deflationary pressures, then this will not bode well for people looking to retire soon. The S&P500 returns with dividends reinvested for 10 years are -2.997[3], so if you had taken money out in 1999 and kept it under your mattress, you would have more cash now than someone who had been invested in the S&P500 the whole time.

The time-honored "buy and hold" strategy only works if you are getting paid to wait (i.e. generation of dividends or interest) for the growth of the investment or if there is inflation in the economy. Inflation causes assets, commodities, wages, and products and services to increase in price. Without inflation, the stock market returns are much more muted, but it is more likely that the returns will remain unchanged or even decline.

Deflation is "*A persistent decrease in the level of consumer prices or a persistent increase in the purchasing power of money because of a reduction in available currency and credit*"[4]. In simple terms this means that as assets, prices and wages decline, cash holds more value. In a deflationary environment, holding for the long term could be devastating for equity portfolios. Effectively, cash is the only asset to invest in which does not decline in value. In nominal terms, a portfolio of cash does not change, but in real terms, the portfolio has gained the amount which would have been lost to deflation. Although this is not as exciting, the returns are very real. If the S&P 500 index has lost 50% and a cash portfolio has returned 0% over the same time period, then in comparison that cash portfolio has effectively gained 100% in real terms. Conversely, in an inflationary environment cash is probably one of the worst investments, as it does not track inflation.

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[1] S&P500 Actual peak is 1,576.09. Oct. 11, 2007 (Source: *The Standard & Poor's Company*)
[2] Source: CNNMoney.com, *"The bear market goes global"*, November 12, 2008
[3] Source: Standard & Poor's Press Release "Standard & Poor's Reports March 2009 Index Returns" (dated March 31, 2009)
[4] "Deflation." *The American Heritage® Dictionary of the English Language, Fourth Edition*

The U.S. is currently experiencing deflation, though few will talk about it; even in the current economy, we do not dare to utter the "D" word. The reason for this is that talking about deflation causes more deflation. In a deflationary environment, almost everything declines in price: commodities, goods and services, wages, assets, etc. Cash is the only asset that does not decrease in value. Why would consumers spend money now, when they know the same products or services will be cheaper tomorrow? As a result, more consumers hold on to cash instead of spending it, thus putting more pressure to further decrease prices. Therefore, deflation causes more deflation. It is a downward spiral, which only ends when things cannot possibly get any cheaper.

Deflation is a rare event caused by the unwinding of leverage and the shrinking of liquid assets. It is one economic phenomenon that the Federal Reserve cannot effectively combat once the federal funds' rate is near or equal to zero. The Fed is currently attempting to fight deflation with reflation, by injecting trillions of dollars into the economy via the existing banking system to prop up asset prices. Theoretically this could work, although I don't believe it will since banks do not appear to be lending in a normal manner and the credit markets are still not operating properly. The major flaw in the reflation theory is that the government can print as much money as they want, but if all this cash sits in banks that do not lend it out, then are we going to see the difference? As long as the newly printed money sits in the banks and does not circulate in the economy, it will not cause inflation. It will only affect the system if it is circulating. It would be more effective to throw money into a crowd from a helicopter.

Another effect of deflation is the impact it has on consumer psychology. People tend to consume less and save more during a deflationary period. The U.S. has been a consumer nation for decades, but once we become savers instead of spenders, it will be very difficult, if not impossible, to change that mindset. The psychology of the consumer started to change in 2005[5], when the U.S. net savings rate was negative. This level has not been matched since 1933. In 2005, consumers have started saving more and paying down their debts. Although this is a positive move for consumers, it is a negative indicator for the economy. When consumers spend less, companies produce less, and, consequently, hire fewer employees. While deflationary downward spiral has just begun, and there is very little that anyone can do to change it.

Unfortunately, our economy will become a test tube. There are very few examples of deflation to examine for possible solutions to our problem. The government and the Federal Reserve will most likely attempt massive changes similar to those undertaken during the Great Depression of the 1930s. This time, however, the Federal Reserve is attempting to reflate the economy by pouring money down the rabbit hole into financial institutions.

As stated earlier, combating deflation only works when the consumers receive the money and use it to purchase goods and services. Unfortunately, as things stand now, the money is being put into banks which are keeping it in their vaults or using it to prop up their balance sheets.

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[5] Net household savings rate in 2005 was -0.5% (Source: U.S. Department of Commerce)

Newspapers and TV commercials are full of stories about how to protect yourself from inflation: gold, silver, and TIPS. These are all good ways to safeguard your investments from a possible hyper-inflationary economic event. The one thing the experts neglect to mention is that these measures will work well WHEN we have inflation. What if inflation does not happen right away? If our government cannot fend off deflation, then all of these investments should have significant asset losses. Investors who are looking to invest for protection against inflation may be disappointed if they have to wait five or more years for inflation to occur, or as in Japan's case, almost 20 years.

Some people, like Bill Gross, a well-known bond guru, postulate that the Federal Reserve would like to have 4.5% 30-year mortgage rates in the near future[6]. This is not an action which shows we have or are experiencing inflation. This is a sign of desperation. The Federal Reserve wants to inject as much inflation into our system as possible to stop deflation but it just may not be feasible to stop decades of inflationary policies from correcting.

It is possible that this will be the first time that massive government intervention could actually help our economy, but somehow I doubt it. While the commonly used phrase, "A rising tide raises all boats" may refer to inflation, I prefer the Warren Buffett phrase, "You only find out who is swimming naked when the tide goes out."[7] If this accurately refers to deflation, then we all have been pantsed.

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[6] Interview on CNBC, December 03, 2008
[7] 2001 Chairman's Letter, Berkshire Hathaway Annual Report

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