

Deflation – what is it and what would it mean for investors?



Oliver's insights

Key points

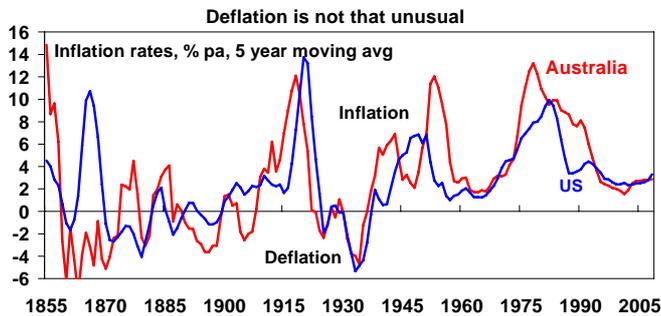
- Global inflation is falling rapidly due to falling oil prices and the economic slump. Next year inflation may turn into deflation, ie, generalised price falls.
- Sustained and uncontrolled deflation would be bad news as it would accentuate problems associated with high debt levels and falling asset prices.
- However, the US Federal Reserve seems to be well aware of the risks and has indicated it will do everything possible to head off a deflationary spiral. It is already embarking on quantitative easing (or "printing money").

From inflation worries to deflation worries

2008 has certainly been an odd year. At the start of the year inflation was a big worry. Now deflation is rapidly becoming a worry as inflation rates around the world are plunging towards zero. So what is deflation? Why is it a problem? What is driving it? What does it mean for investors? And how likely is sustained deflation?

Deflation – what is it?

Deflation refers to persistent and generalised falls in prices. In other words, the underlying consumer price index would decline. A long run of history shows that deflation is not a particularly unusual phenomenon. Deflation occurred in the 1800s, 1930s and more recently in Japan.



Source: Global Financial Data, AMP Capital Investors

However, whether deflation is a good thing or not depends on the circumstances in which it occurs. Lower prices are good for consumers because they increase the purchasing power of their income, but not if they are associated with falling wages, rising unemployment and falling asset prices. For example, in the 1930s and more recently in Japan, deflation reflected economic collapse and rising unemployment made worse by the combination of high debt levels and falling asset prices ("bad deflation").

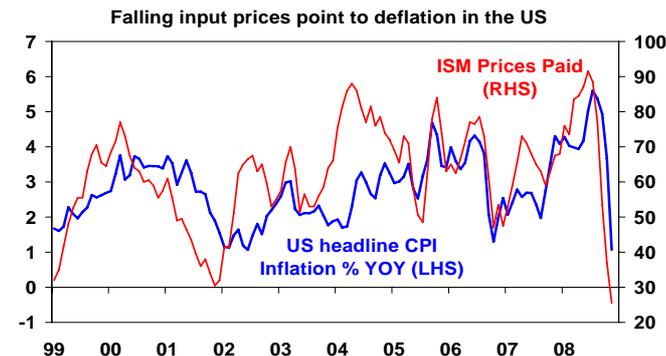
In the current environment deflation could cause serious problems because household debt levels are high in many

countries. Sustained deflation would increase the real value of debt at a time when asset prices are falling and nominal incomes are weakening. If individuals attempt to reduce their debt burden by cutting spending (which only intensifies deflationary pressures) and selling assets (causing further falls in asset prices), the risk is that a vicious "debt deflation" spiral may take hold.

But not all deflation is bad. In the period 1870-1895 in the US, deflation occurred against the background of strong economic growth, reflecting rapid productivity growth and technological innovation, ie "good deflation". Falling prices for electronic goods are an example of good deflation.

Potential drivers of deflation

Right now, given the global economic slump, high household debt levels in key countries and falling asset prices, **the main concern is that we will see a bout of "bad deflation"**. The past few months have seen headline inflation rates fall sharply. US inflation has fallen from a peak of 5.6% over the year to July to just 1.1% over the year to November and its still falling. So far Chinese inflation has fallen from a peak of 8.5% in April to 2.4% in November. Inflation is also rolling over in Europe and Japan and based on the TD Securities Inflation Gauge is also starting to fall in Australia. So far the main driver of the slump in inflation has been falling oil and food prices, but underlying inflationary pressures have also turned as companies are turning to discounting to sell goods in the face of weak demand. Indications are that inflation will fall further. For example, a survey of US manufacturers in terms of the prices they are paying for inputs has fallen to its lowest level since 1949. This points to US inflation falling into negative territory early in 2009. See next chart.



Source: Thomson Financial, AMP Capital Investors

Similarly inflation is likely to fall in other countries leading to deflation worries next year. There are two key drivers:

- Firstly, the slump in commodity prices, particularly oil, is cutting inflation directly via lower petrol prices and indirectly via lower raw material prices.
- Secondly, underlying inflation pressures will fall in normal lagged response to the global recession. This is because the recession will lead to global spare capacity and this leads to discounting putting downward pressure on prices (or the rate of increases in prices). Excess capacity in Chinese factories will also see China return to its position of exporting deflation to the rest of the world in order to help keep its exports up. The US recessions of the mid-70s, early 80s and early 90s were associated with falls in US inflation excluding food and energy of six, nine and 2.5 percentage points respectively. A 2.5 percentage point fall in US core inflation from its recent peak would take it to zero.

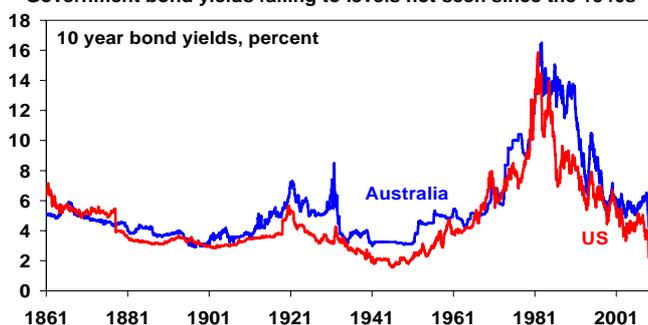
Deflationary forces will also be felt in Australia as global prices fall and excess capacity opens up due to the slump in local growth. This may be partly offset by the lower \$A pushing up import prices and the (hopefully) milder recession locally. Nevertheless, inflation is likely to fall well below target (ie 2-3%) over the next two years.

What would sustained deflation mean for investors?

As a general rule an outbreak of sustained deflation, ie falling prices spread over several years, would favour government bonds and cash over equities, property and corporate bonds for investors. Out of control deflation presents a particular risk to listed companies because they tend to have a higher exposure to goods where pricing power is weakest as opposed to services and of course it would cut into property rents. However, share markets and corporate bonds have already fallen sharply consistent with their having already factored in a rough time ahead.

Government bond yields have also had sharp falls but deflation fears along with moves by central banks (led by the US Federal Reserve) to buy them could push yields even lower (producing capital gains for investors). In a world of sustained deflation or very low inflation bond investors would come to factor in sustained low cash rates and could push US ten year bond yields (now 2.2%) down to Japanese levels (ie around 1.5%) and Australian bond yields (now 4.1%) well below 4%. Ten year bond yields in the US are already at their lowest since January 1951 and in Australia are at their lowest since March 1952.

Government bond yields falling to levels not seen since the 1940s



Source: Global Financial Data, AMP Capital Investors

Cash is also a safe bet in a deflationary world – capital is protected (provided it is left in a safe institution) and after allowing for inflation the real return is reasonable. That said further falls in official interest rates (to around 2.5% in Australia by mid next year) will mean the yield on cash will slide to much lower levels.

How likely is a sustained period of “bad deflation”?

Before becoming too concerned we need to assess how likely a period of sustained deflation really is. As noted earlier a swing into deflation is likely next year in the US and in some other countries as well. However, the risk of a persistent and generalised 1930s or Japanese style bout of deflation in the world as a whole or in the US is modest:

- Firstly, while goods price inflation in the US, Australia and elsewhere is likely to become very weak or negative, services price inflation is relatively resilient. This is partly because services prices have a higher wage element and wages are often sticky downwards, and there is less excess capacity in services industries.
- Secondly, central banks possess sufficient means to avoid sustained deflation. US Federal Chairman Ben Bernanke addressed this issue back in 2002 when deflation was last a worry and when he was a Fed Governor. Bernanke laid out the Fed’s deflation fighting tool kit which included committing to hold the key Fed Funds rate at zero for some time, buying private sector debt and “printing money” to buy government bonds. **Recent pronouncements from the Fed including the move to a zero to 0.25% interest rate and indicating it will hold it there for “some time”, moves to buy private sector securities and indications that it is considering buying government bonds indicate it is now starting to use its anti-deflation tool kit in full.**

Central banks have studied the 1990s Japanese experience, where Japan eased monetary policy too slowly letting deflation become entrenched. The Fed has now got to a Zero Interest Rates Policy (or ZIRP) and quantitative easing (where money supply growth is targeted) in 14 months from the Oct 2007 peak in the share market whereas it took the Japanese over 9 years from the time of the peak in Japanese shares in Dec 1989 to ZIRP in 1999. So while there are a lot of parallels with 1990s Japan, things are moving a lot faster in the US this time around. Similarly, the current situation is very different to the early 1930s when interest rates were initially increased and the money supply was allowed to collapse. With the Fed acting aggressively, a period of persistent and generalised deflation is likely to be avoided, albeit the risk is worth monitoring. Other central banks, including the Reserve Bank of Australia with its rapid fire rate cuts, seem just as determined as the Fed to head off a severe debt deflation spiral. Perhaps the European Central Bank is an exception.

On the flipside, fears that quantitative easing or “printing money” will just lead to an inflationary surge are not justified in the current environment where such policy action is simply offsetting deflationary forces flowing from a lack of private sector spending resulting in excess capacity.

Concluding comments

With commodity prices, notably the oil price, falling sharply and most countries now starting to experience excess capacity, a period of deflation or at least very low inflation is likely in 2009. Fortunately, the risk of a sustained bout of deflation as in the 1930s or in Japan in recent times is modest. The US Federal Reserve, along with the RBA & most other central banks, are well aware of the risks and appear to be doing whatever is necessary to avoid it.

Dr Shane Oliver
Head of Investment Strategy and Chief Economist
AMP Capital Investors

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