Money, Money Everywhere ...

Despite the ongoing efforts of central banks to debase their currencies through increasing their monetary bases and some outright calls for devaluations, consumer prices remain weak across much of the developed world, and many market observers have begun to focus on the too-real possibility of the global economy falling into a deflation "trap." Deflation now exists in nine of 34 developed countries, while two have flat year-over-year consumer prices and another nine have inflation of less than 1%.

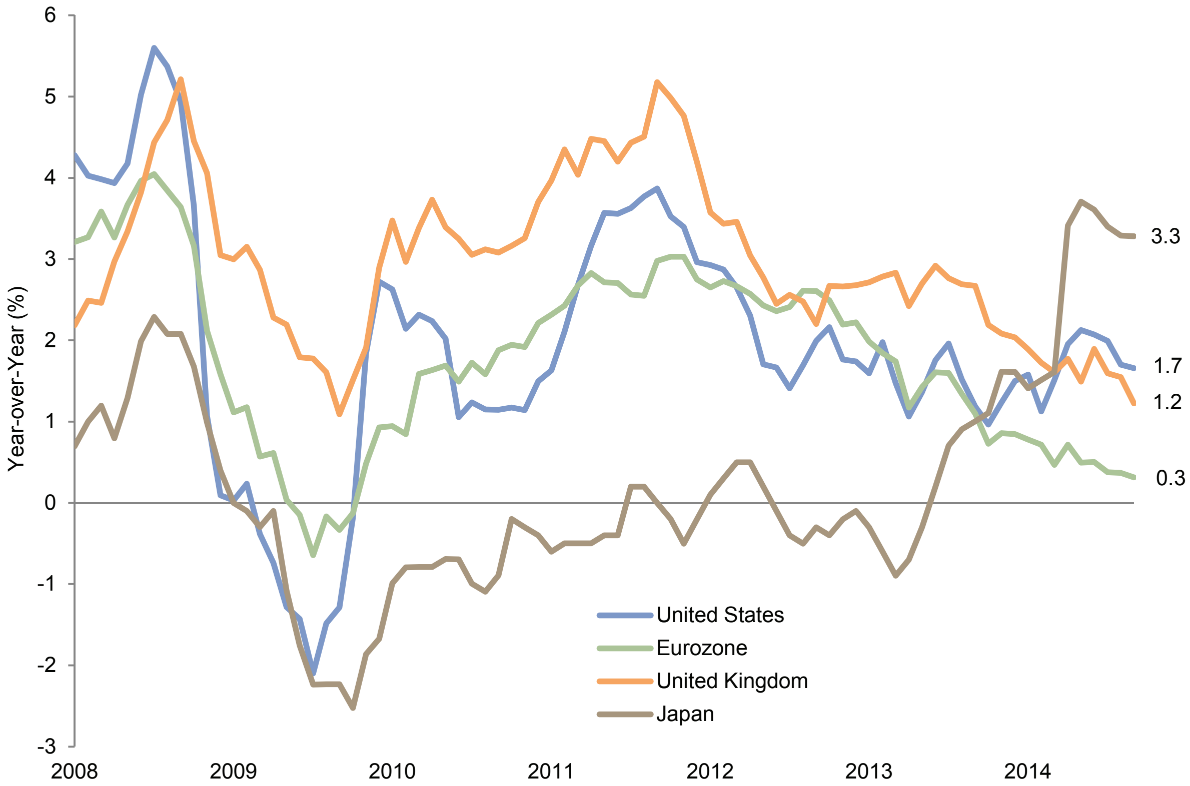
While deflation is indeed a problem, it poses a risk *not* because rising prices for goods and services are unambiguously good, but because of the over-indebted nature of the global economy. Despite the alarmist language thrown around by many—a recent *Wall Street Journal* article,[1] for example, warned of the "specter of deflation," and called on central banks to fight its "debilitating effects"—falling prices are not, in and of themselves, always frightening. To cite one obvious example, lower gas prices should, *ceteris paribus*, boost consumers' ability to spend money on other items.

The reason deflation is a concern today is the over-indebted state of the world. In the end, the debt load simply becomes more difficult to eliminate under a deflationary scenario as it cannot be "inflated" away. Thus, we agree with the consensus on three things: broad-based deflation is a growing threat, it would be very damaging to the world economy as currently structured, and policymakers will move heaven and earth to prevent it. However, the alternative to deflation—i.e., current policies aimed at increasing inflation partly through broad-based currency debasement—will not fix the debt problem, but rather could simply delay and exacerbate the ultimate cost of the much needed global deleveraging. There is no painless way to "fix" the unbalanced and highly leveraged global economy.

C|A research publications aim to present you with insights from a variety of different viewpoints. The views of our Chief Investment Strategist can be found each quarter in VantagePoint.

[1] Jon Hilsenrath and Brian Blackstone, "Risk of Deflation Feeds Global Fears," *The Wall Street Journal* (October 16, 2014).

Year-over-Year Change in Regional Inflation
January 31, 2008 – September 30, 2014



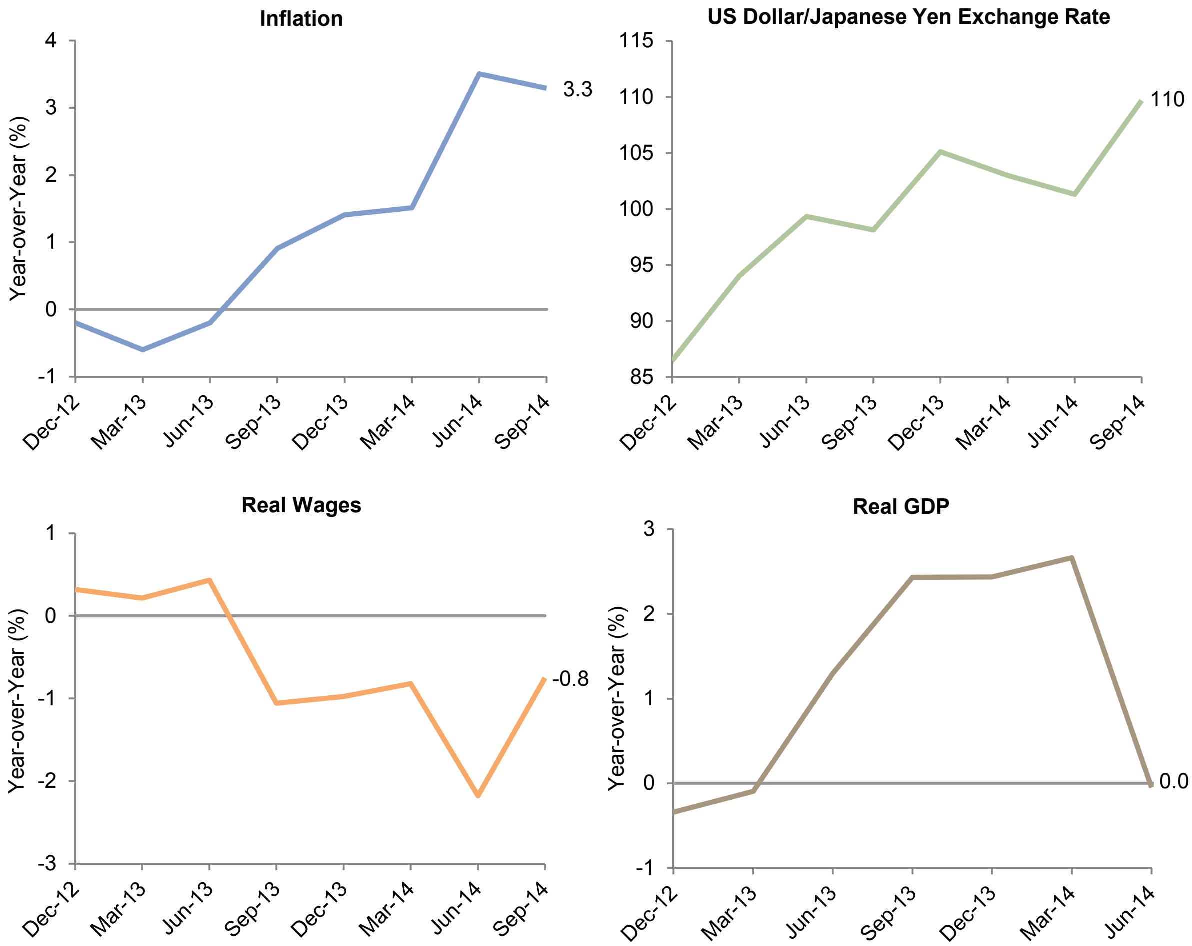
Fear of Falling … Prices?

Before discussing the current deflation possibilities, it is important to define the issue. First and foremost, while many people talk of "inflation" as a measurable quantity—the US CPI, in a classic example of false precision, is calculated to *three decimal places*—the idea that "prices" are some sort of monolithic entity that move in tandem with each other is observably incorrect. Nevertheless, the conventional wisdom on prices is not only that they can be measured, but also that if countries with low inflation "tip" into deflation (i.e., the CPI falls below zero), they run the risk of falling through a sort of financial wormhole to become trapped in a 1930s-style Depression. As the *Wall Street Journal* story put it, "Japan's struggles to exit deflation, even with massive central-bank stimulus, illustrate just how difficult it is for an economy to pull out of the trap, once it has settled in." The idea that low prices have *caused* the Japanese economy to stagnate over the past 25 years is a highly debatable proposition. And yet the view that the Japanese economy is "trapped" in some sort of low-growth purgatory because people do not have to pay more yen for the things they buy has become not only accepted dogma, but banal to the point of boilerplate.

Our view is that such analysis has it exactly backward. While Japan's (originally) much-lauded Abenomics plan—which was designed to "pull the country out of the trap"—has boosted prices, real wages have *fallen* and GDP growth has been meager at best. This should hardly be a surprise, as true money-printing (as distinct from what other developed markets central banks are doing, which we discuss later) has no historical evidence of boosting *real* growth, but rather a distressing record of economic destruction through the debasement of currency (see Argentina, Austria, Germany, Venezuela, Zimbabwe, etc.). The inconvenient truth, meanwhile, is that inflation caused by printing money almost always favors the wealthy—who have access to the new cash through borrowing and investments—and *hurts* those further down the income/asset ladder who must pay higher prices for things they buy, but do not benefit from asset appreciation or higher *real* wages. This is one of the primary drivers of inequality today as asset price inflation has primarily benefited a select few.

Japanese Economic Indicators Post-Abenomics

Fourth Quarter 2012 – Third Quarter 2014




When pressed, those who warn of the dangers of deflation will argue along the following lines: if people expect goods to be cheaper a year from now they will delay purchases, depressing demand and thus production in a vicious spiral. And this sounds reasonable until one looks at real world examples. Computers and cell phones have been arguably the most "deflationary" sectors for some time and yet demand for such products continues to hit new peaks. Indeed, consumers eagerly line up for every new iPhone *despite* knowing Apple will release a better, and possibly cheaper, version next year, and the year after that, ad infinitum.

What About Central Banks?

It is also important to understand the reality of what central banks have, and have not, actually done in recent years. The widely accepted notion that they have "printed money" is a bit of an oversimplification. The Federal Reserve, for example, has boosted its balance sheet by more than $3 trillion over the past few years, but the vast majority of this cash continues to reside at the Fed in the form of excess reserves and will remain so unless and until the Fed removes it. Short of borrowers taking money in cash and stuffing it under a mattress, any loan by definition results in an offsetting asset and liability for the system as a whole, and thus excess reserves do not change.[2] Said a different way, very little of the money "printed" by the Fed has found its way into the non-financial economy. While lower interest rates have almost certainly boosted corporate borrowing, such relatively minor effects are significantly different than claims the Fed is "injecting money" into the economy.

One could, however, argue this money has found its way into financial markets by providing additional capital to backstop banks' proprietary trading activities—which do require varying levels of reserves—although given the fungibility of bank earnings this is unprovable one way or the other.[3] And we have little doubt that as the "specter" of deflation looms larger, central banks will look for more direct methods of "injection."[4] But for the moment, barring a surge in wage growth or a substantial increase in consumer borrowing, current central bank activities appear unlikely to do much to boost consumer prices.

[2] For an excellent discussion of this topic see Paul Sheard, *Repeat After Me: Banks Cannot and Do Not "Lend Out" Reserves*, Standard & Poor's (August 13, 2013).

[3] For an interesting and amusing take on this we recommend Matt Levine, "Bank of America Made $168 Million Last Quarter, More or Less," *Bloomberg View* (October 15, 2014).

[4] As suggested in this recent piece: Mark Blyth and Eric Lonergan, "Print Less but Transfer More: Why Central Banks Should Give Money Directly to the People," *Foreign Affairs* 93, no. 5 (September/October 2014).

Three Questions

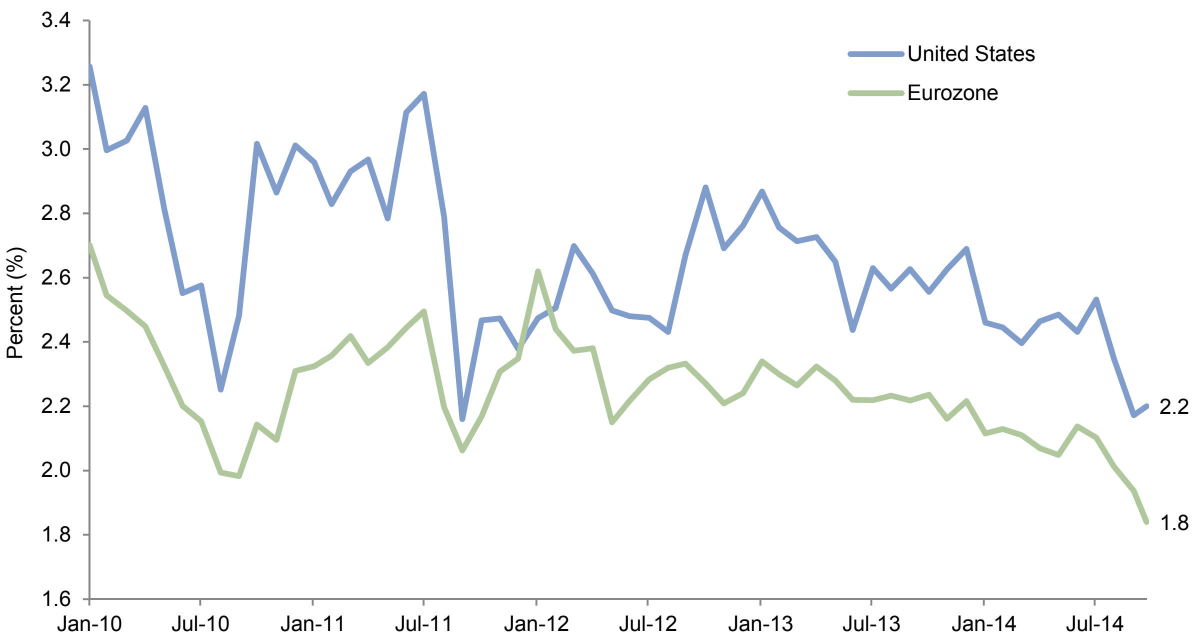
As we see it, there are three (related) questions investors should be asking about deflation:

- How widespread is it?
- What is causing it?
- How much, if at all, should we worry about it?

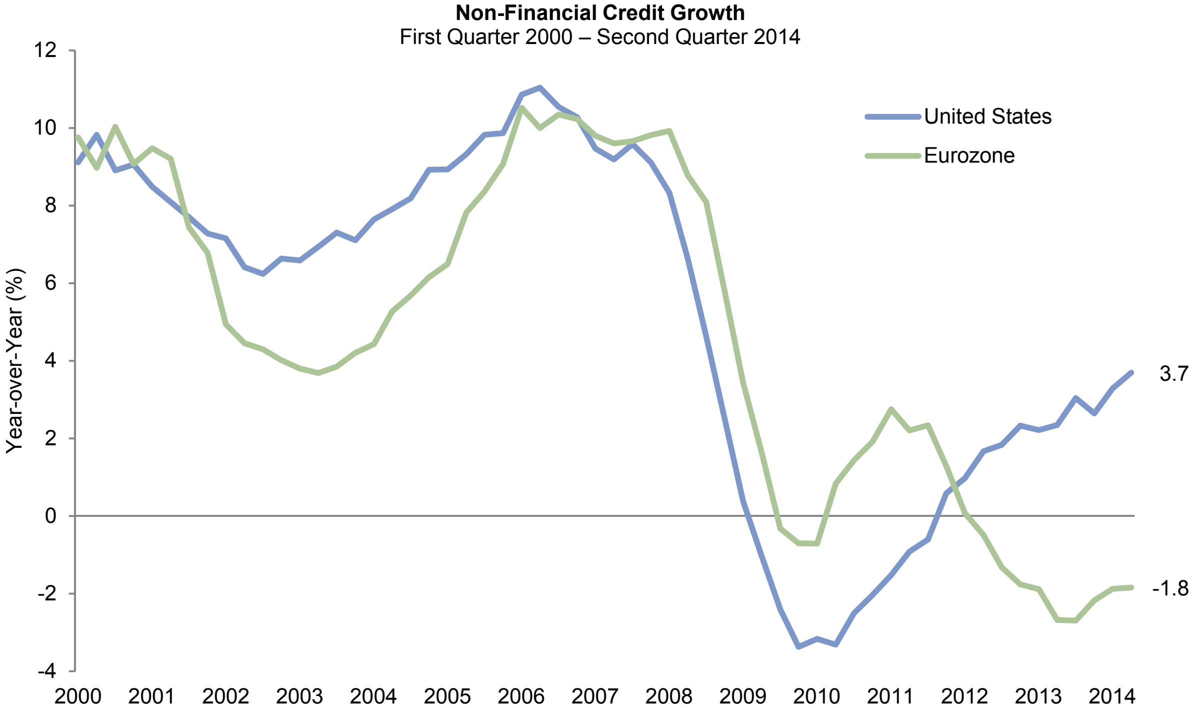
The first is obviously the easiest to answer. Consumer price indexes across the developed world remain low if not negative,[5] with most showing a declining trend.[6] The newly fashionable "five-year five-year" inflation expectations—which measure implied market inflation expectations for the five-year period that starts five years from today—have also turned down for the Eurozone and the United States.[7] That said, deflation worries in the United States are less pronounced due in large part to the recent uptick in credit growth, which may explain the concurrent gap between US and core European sovereign yields.

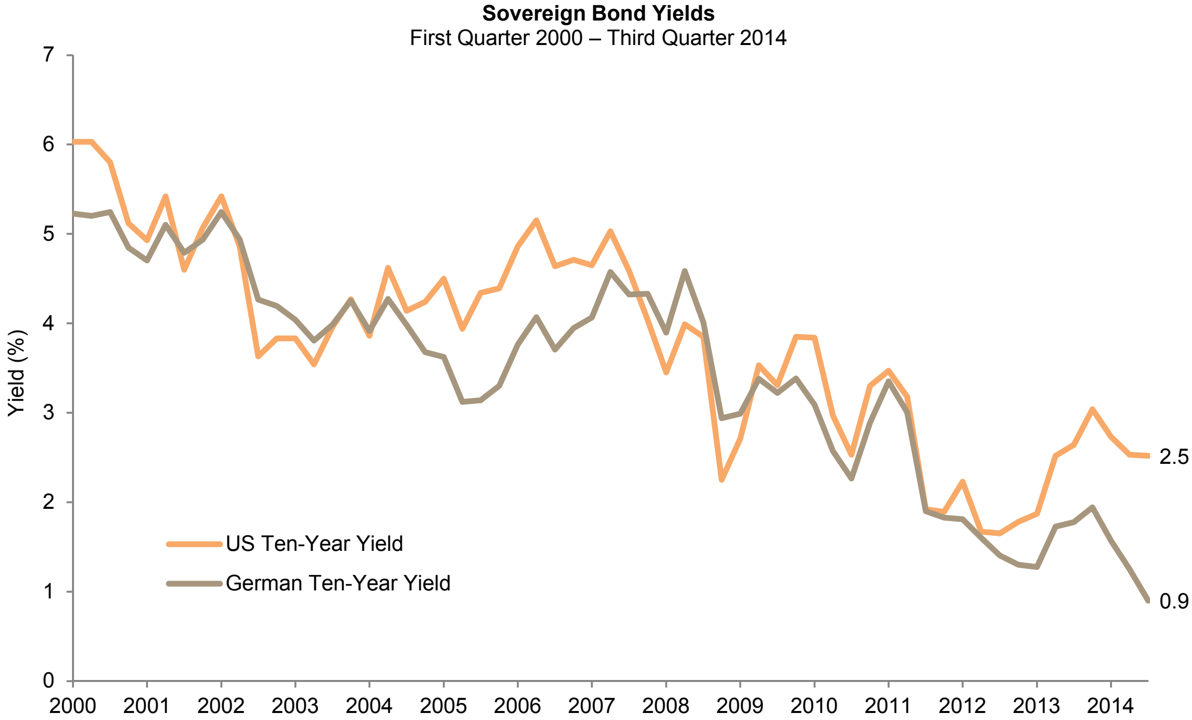
[5] Emerging markets, by contrast, have struggled more with *in*flation in recent years, although the recent decline in commodity prices has mitigated this.
[6] For the purposes of this brief we will leave aside discussion of the reliability of such indexes, and simply accept them as the best gauge of broad consumer prices.
[7] We are bemused by the sudden popularity of this metric. As Jim Grant recently opined, "How much anybody could possibly know about the future starting in five years (or, for that matter, five months) is another question."

Five-Year Five-Year Forward Inflation Expectations
January 31, 2010 – October 21, 2014



Non-Financial Credit Growth and Sovereign Bond Yields





The second question is somewhat more complicated. In our view, the reason consumer prices have remained stagnant in recent years is that (a) current demand has been sapped by the 2003–07 credit bubble, which pulled forward an enormous amount of consumption that is still being "worked off," and (b) while QE programs writ large[8] have driven down interest rates and boosted risk assets—and thus been incredibly lucrative for asset holders and banks—very little of this money has found its way into the rest of the economy. This has perhaps been best exemplified by the phenomenon of strongly rising US profits on the back of weak sales, as corporations have borrowed money at very low rates and used the proceeds mainly to refinance existing debt and buy back stock, thus driving down their interest costs and boosting earnings *per share* despite weak top-line growth. Another way of putting this is that there *has* been inflation, but in financial assets rather than consumer prices.

With regard to the third question, we would distinguish between "good" deflation (e.g., technological progress that makes consumer products cheaper) and the "bad" variety that follows an unsustainable credit expansion. It is indeed true that "bad" deflation poses a clear and present danger to the global economy given its unbalanced and over-indebted nature. One need only consider what would happen to the US or UK housing markets were prices to drop 10% (or 20%) from current levels. Most importantly, deflationary forces do appear to be gaining strength despite the best efforts of central bankers.

But perhaps the most significant reason to worry about deflation is that, as previously discussed, efforts to forestall it may only make the ultimate endgame more painful for all as the "cure" continues to be the layering on of ever more debt in an attempt to delay the necessary global deleveraging as long as possible.

The Bottom Line

Deflation is beginning to spread across major economies due mainly to the ever-growing global debt overhang and the ineffectiveness of central banks at injecting money into the real economy rather than the financial one. However, while this is certainly worrisome due to the over-indebted global economy, efforts to forestall the needed deleveraging may, in the end, exacerbate it. Indeed, the conventional wisdom that increases in *nominal* prices should be linked with *real* economic growth is contradictory on its face. That said, given the importance most investors place in this link—coupled with the narrative of central banks' ability to control economic outcomes—we fully expect central banks to continue to expand their toolkit if deflationary pressures mount. ■

[8] Including the European Central Bank's ability to talk down peripheral spreads without actually *doing* anything.


Contributors

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Exhibit Notes

Year-over-Year Change in Regional Inflation
Source: Thomson Reuters Datastream.
Note: Inflation data are not seasonally adjusted.

Japanese Economic Indicators Post-Abenomics
Sources: MSCI Inc., OECD, and Thomson Reuters Datastream. MSCI data provided “as is” without any express or implied warranties.
Notes: Real GDP data are through second quarter 2014. Inflation data are not seasonally adjusted. All data are quarterly.

Five-Year Five-Year Forward Inflation Expectations
Source: Bloomberg L.P.

Non-Financial Credit Growth and Sovereign Bond Yields
Sources: European Central Bank, Federal Reserve, and Thomson Reuters Datastream.