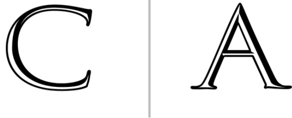

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GLOBAL MARKET COMMENT: DEFLATION WATCH—RISING RISKS?

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Deflation Watch - Rising Risks?

In past *Market Updates*, we have periodically examined the deflationary undercurrents that have been unleashed by specific events and trends. Given that the United States is now officially in recession and Europe has only technically skirted recession at the same time that deflationary forces abound, we revisit the topic once again. The global economy has shown few signs thus far that monetary easing and the promise of increased fiscal spending have worked, prompting further concern that the global economy is headed for deflation, and, possibly a liquidity trap.

The Demise of Inflation

Global consumer price inflation has been steadily declining over the last 20 to 25 years (see Table A). The Producers Purchase Index (PPI) in the OECD is down sharply from its recent peak last June, although still above record lows of the last two decades. In the United States, October's drop in PPI was its largest monthly decline since 1947 when the series began. Rock-bottom commodity prices and falling U.S. import prices have intensified global disinflationary pressures (see Table B). The Journal of Commerce index has sunk to a low not seen since 1987, while the energy-heavy Goldman Sachs Commodity Index has fallen 33.9% from its high in November 2000. In addition, prices of imports in the United States—by far the world's largest importer, accounting for 19.3% of all global imports in 2000—have dropped dramatically. Cheap exports from China represent a deflationary force that undermines pricing power from other developing economies. Deflationary pressures from China are likely to increase as China's inexpensive labor and arguably cheap currency make it the most likely candidate to serve as the world's factory, particularly following its entry into the World Trade Organization in November of this year.

The recent drop in inflation can be partially attributed to the severity of the current global economic downturn. G7 industrial production growth is shrinking rapidly, while manufacturing capacity utilization has dropped to 20-year lows in the United States and Japan, though it is slightly higher in Europe (see Table C). Prices have dropped most dramatically in technology, but they are falling in the auto, furniture, apparel, paper, and steel industries as well. In addition, weakening global labor markets will probably restrain compensation costs and service sector inflation over the next few years.

When Good Disinflation Goes Bad

Disinflation is usually a benign force that cushions the impact of an economic slowdown by relieving inflationary pressures that built up during the preceding upturn. Disinflation becomes malevolent

when the downturn decimates aggregate demand and increases excess capacity to painful levels, which triggers a downward spiral of falling prices, shrinking demand, declining employment, and financial distress. Deflation gives consumers the incentive to save or postpone spending because they believe, rightly, that prices will fall, thereby depressing production and putting additional pressure on pricing power. In this environment, firms can only cut costs by cutting salaries or laying off additional workers, which deepens the recession. Deflation also hurts borrowers because they must repay their debt in more valuable currencies.

The danger of the current environment lies in how normal cyclical factors will react within the larger canvas of a global landscape that has changed enormously over recent years. In the current cycle, disinflation may become a destructive force due to the diffusion of technology, pervasiveness of globalization, and the unwinding of the bubble's excesses. Globalization and technology represent secular disinflationary forces that intensify competition and ultimately put downward pressure on margins and prices. From a policy standpoint, low interest rates and low inflation reduce the flexibility of central banks to reduce interest rates, which is a tool that usually brings about recovery. Furthermore, the ongoing reversal of the wealth effect, by discouraging spending, is equivalent to a tightening of monetary conditions.

Odds Against Deflation - At Least for Now

Observers who warn about the dangers of deflation and a liquidity trap usually highlight the case of Japan, with consumer prices falling at an 0.6% annual clip, while monetary policy and lower interest rates have been ineffective in easing financial conditions. Investors should treat parallels between Japan and other developed economies with a good deal of skepticism, however. First, deflation is usually precipitated by policy errors, not by poor economic fundamentals by themselves. Japanese leaders fell under harsh criticism for not acting quickly or resolutely enough to head off recession and deflation, while most other major central banks are urgently trying to reflate their economies. OECD broad money supply is accelerating at a 17.8% rate, the fastest it has grown over the 20-year period for which we have data (see Table C). Second, key short-term interest rates of developed economies remain in positive territory, and until they fall to zero, it is premature to worry about a liquidity trap. Third, it is unlikely that monetary policy in developed economies will be as ineffectual as in Japan because the financial systems of other developed economies are fundamentally stronger.

While the global economy is undergoing disinflation, we rate the prospect of falling into a deflationary cycle or liquidity trap as unlikely. However, deflation cannot be ruled out. The circumstances that would precipitate it or a liquidity trap include:

- Persistent weakness in the drivers of consumer spending, such as employment rates, income levels, equity prices, and housing prices. All of these have thus far tightened financial conditions and underscored the inability of monetary policy to lift the global economy thus far.
- A further decline in household and business confidence, which would depress spending and investment, and exacerbate excess capacity.
- Continued increase in risk aversion, which would raise the cost of capital, thereby choking off investment.

In contrast, if massive reflationary efforts by major central banks were working, the results would be seen in rising commodity prices, higher interest rates, increases in global capacity utilization, and a rise in prices of traded goods.

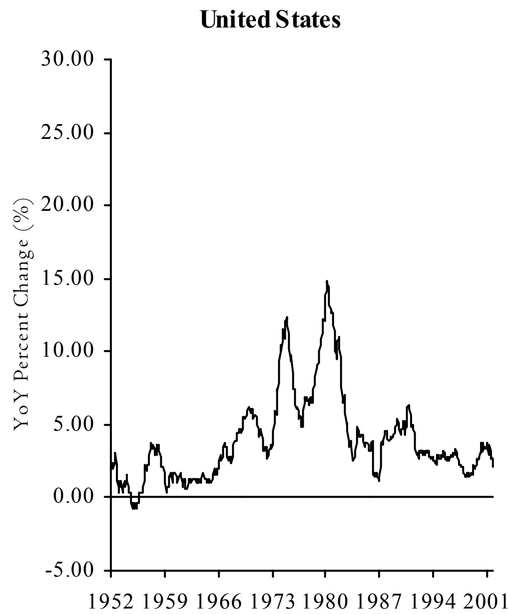
Investment Implications

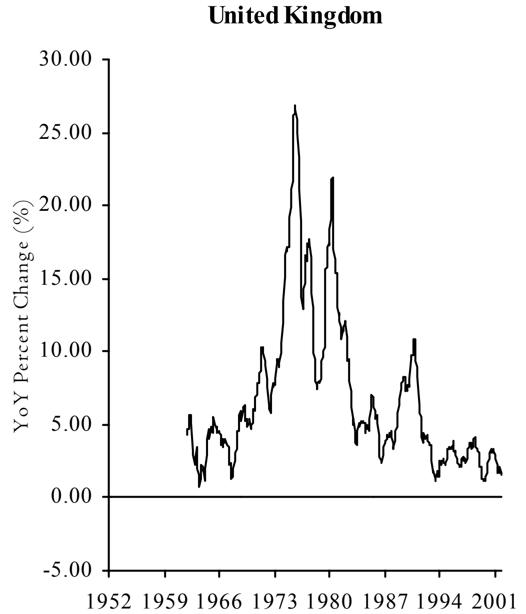
While we regard the probability of deflation as low, its effects would be devastating to portfolios holding significant amounts of equities. Therefore, investors should hedge against the possibility of deflation, as well as a prolonged economic contraction, by holding high-quality, intermediate- to long-duration bonds. In the current environment of extremely low short-term interest rates and widespread expectations of higher rates in the future, investors should resist the urge to move into short-term bonds. Short-term bonds would not provide protection during deflation, and might also prove to be a poor investment in the event that the economy recovers, as the markets price in the expectation that central banks will become more likely to raise rates in order to reign in inflation. In fact, short-term rates have risen in November, as markets have reflected more investor optimism regarding an economic turnaround next year, while long-term rates have remained relatively stable. In addition, market timing historically has proven to be a losing proposition, a point that is reinforced in the semiannual *Wall Street Journal* survey of approximately 50 economists' interest rate expectations for 30-year Treasuries six months ahead. Over the 39 six-month periods for which *The Wall Street Journal* has been conducting this survey, the consensus forecast yield has been in the wrong direction in 28 periods, or 72% of the time. Therefore, the time and energies of investment committees are most productively spent designing the most appropriate long-term asset allocation strategy, rather than trying to time the markets.

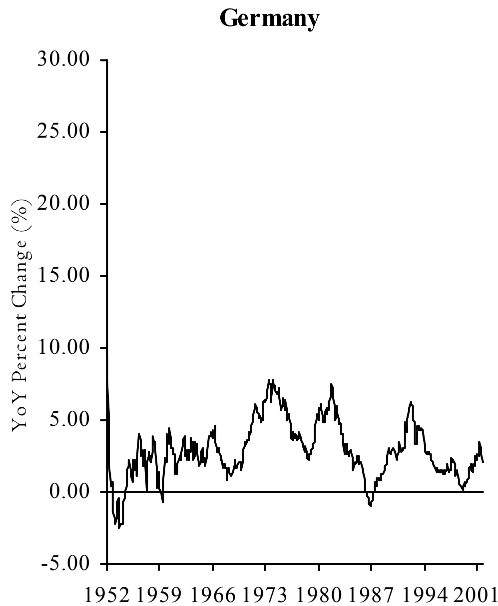
Table A

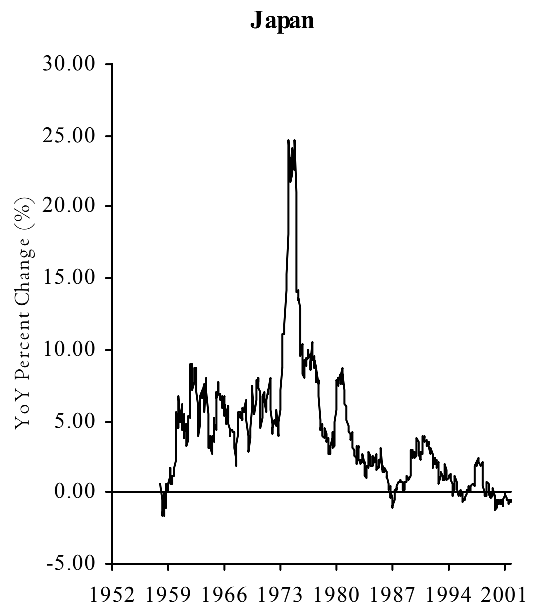
CONSUMER PRICES FOR DEVELOPED ECONOMIES

February 1, 1951 - October 31, 2001







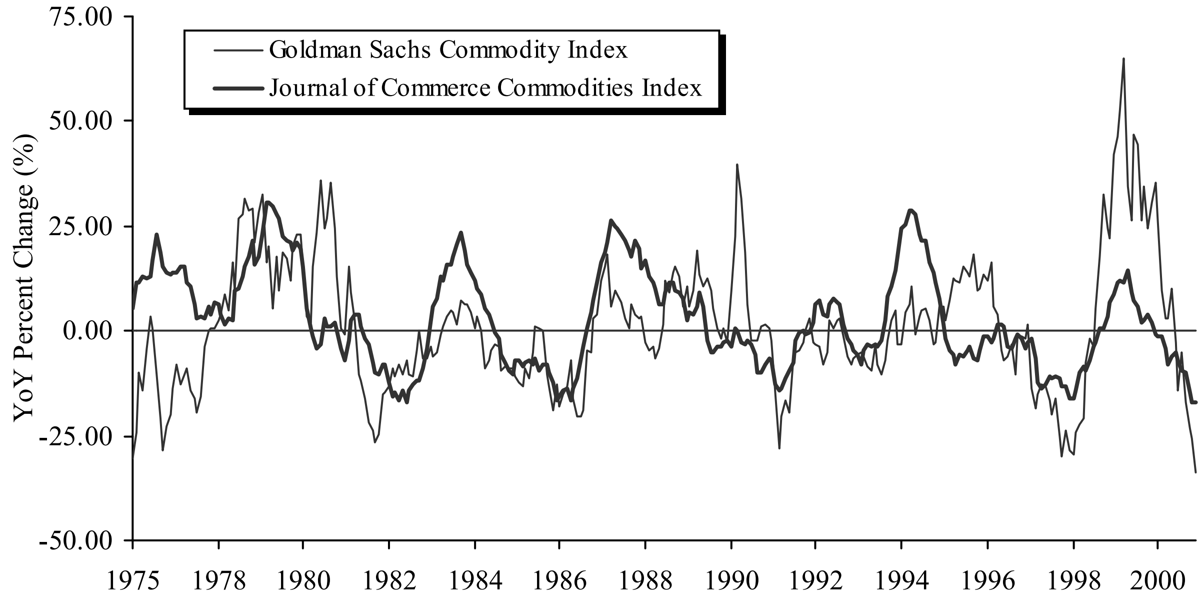


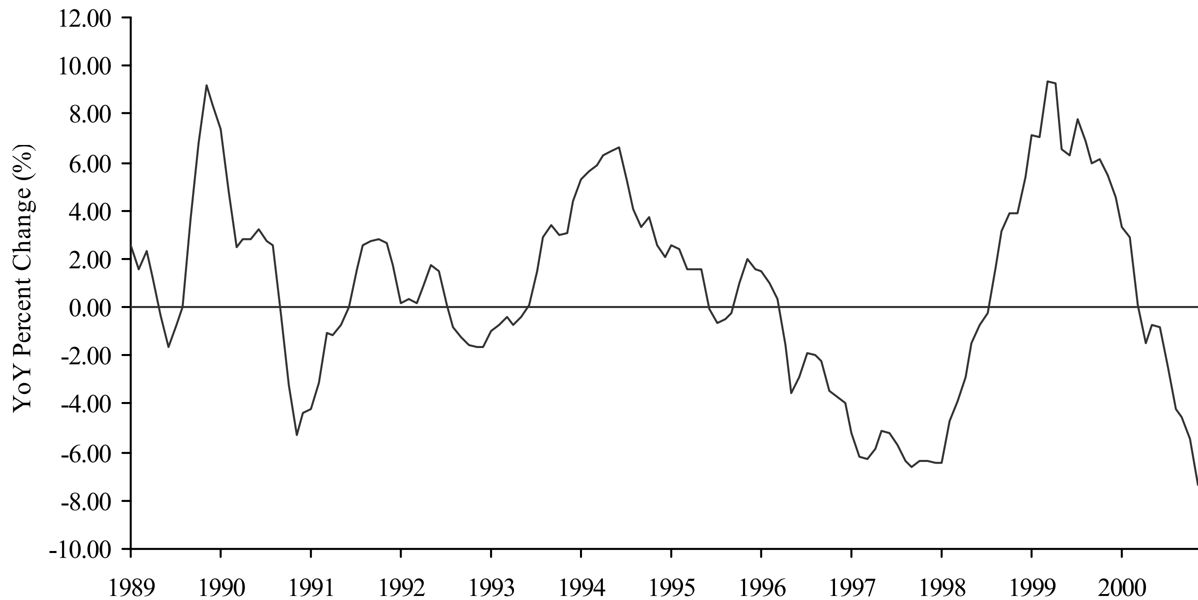
Sources: Bureau of Labor Statistics and Datastream International.

Note: U.K. RPI data are from January 1, 1961 and Japanese CPI data are from February 1, 1957.

Table B

COMMODITY AND IMPORT PRICE GROWTH



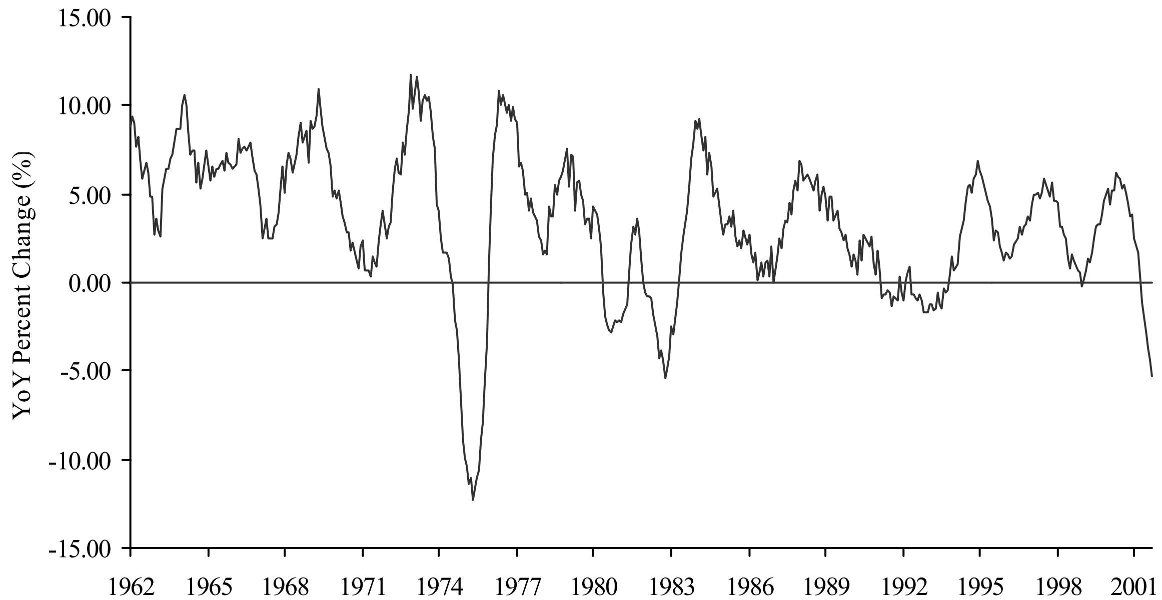


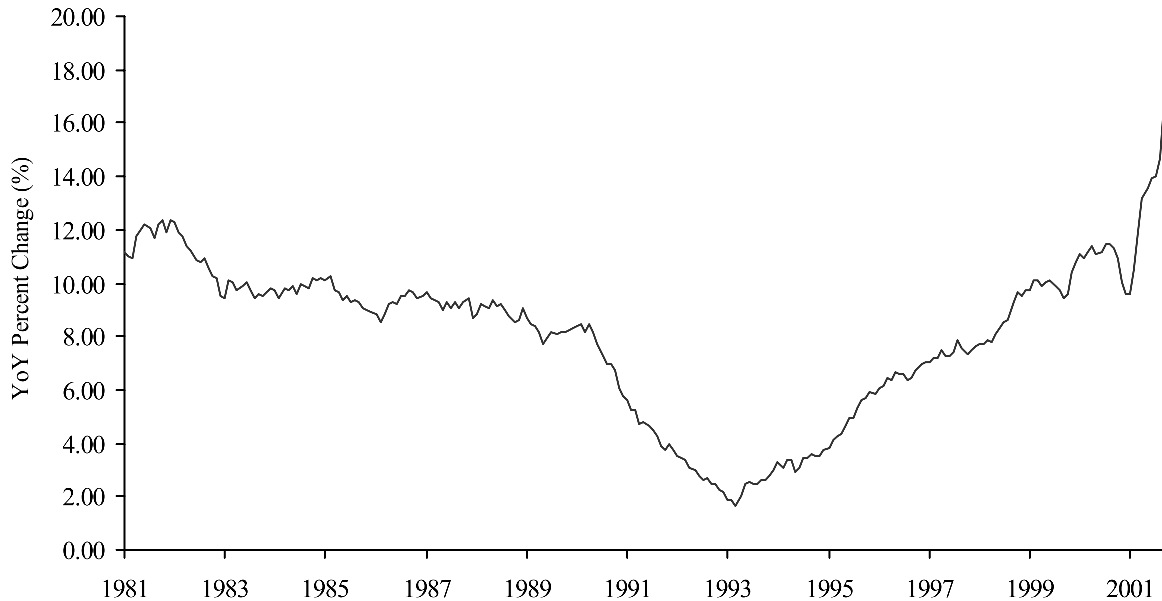
Sources: The Bloomberg and Datastream International.

Note: All data are in nominal terms.

Table C

OECD INDUSTRIAL PRODUCTION AND BROAD MONEY SUPPLY





Source: Datastream International.

Note: Broad money supply is defined as M2 plus.