Thinking About Deflation?

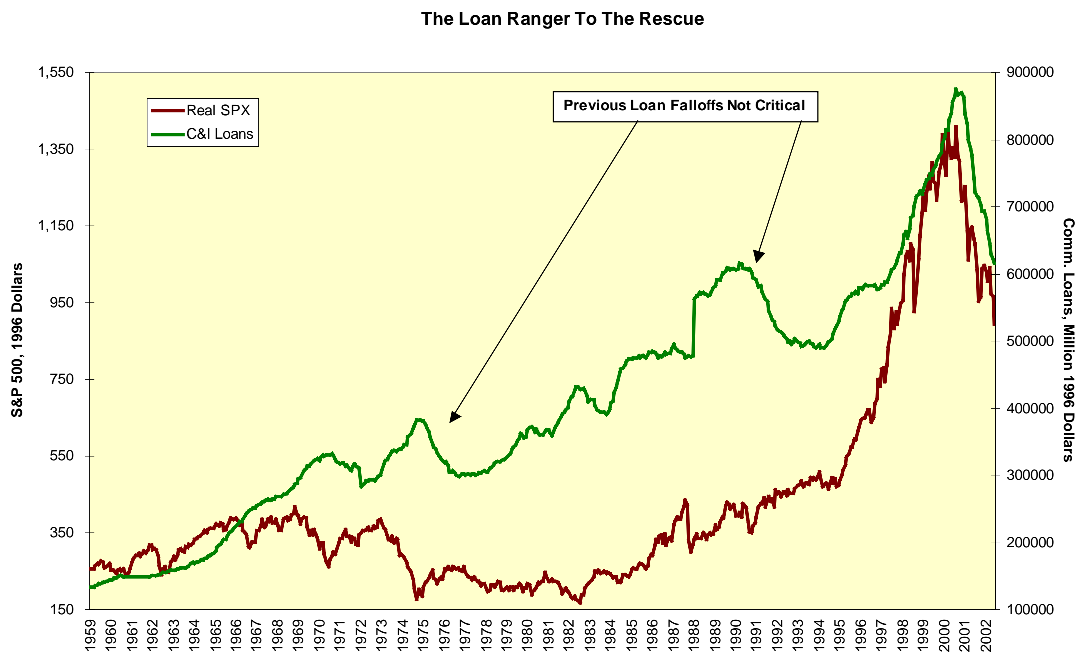
Generals fight the last war, investors focus on happier days, and policy decisions are made at 80 miles per hour while looking only at the rearview mirror. Past performance does not predict future results, but what else are you going to use?

Just this past spring when the economic data were coming in rosier and the S&P 500 was in the process of making its fourth and fatal failure in front of 1175, I opined that the sharp growth in the monetary base produced by the Fed's series of rate cuts could lead to an explosive jump in the money supply – and here's the hoot, a stock market rally – once credit spreads declined and commercial loan demand resumed growing. A given supply of base money, defined as cash plus reserve deposits in central banks, is multiplied through bank lending, or credit, into the final money supply measured as various M's.

Even though bank lending is not as central to corporate financing as it once was – many borrowers go directly to the commercial paper market instead – it is an important measure of both credit demand and overall financial system liquidity. As noted here last week, risk acceptance in stocks cannot occur without narrower credit spreads in corporate bonds, and that in turn won't occur until banks are willing to lend from their own balance sheet. After all, if banks, whose secured loans stand at the apex of corporations' capital structure seniority, aren't willing to supply funds, why should bond investors or, last in line, common stock investors?

If we overlay the Conference Board's index of commercial and industrial loans, which are deflated to 1996 dollars by the personal consumption expenditures deflator, to a similar "real dollar" S&P 500, we can see just how sharp the decline in bank lending has been. Moreover, previous downturns in the recessions of 1974-1975 and the early 1990s did not correspond to equally severe downturns in stocks, not even on a lagging basis.

Bottom line: The present implosion of risk acceptance, while not regarded commonly as a "credit crunch," is threatening the money supply's growth, which in turn is threatening deflationary pressure.

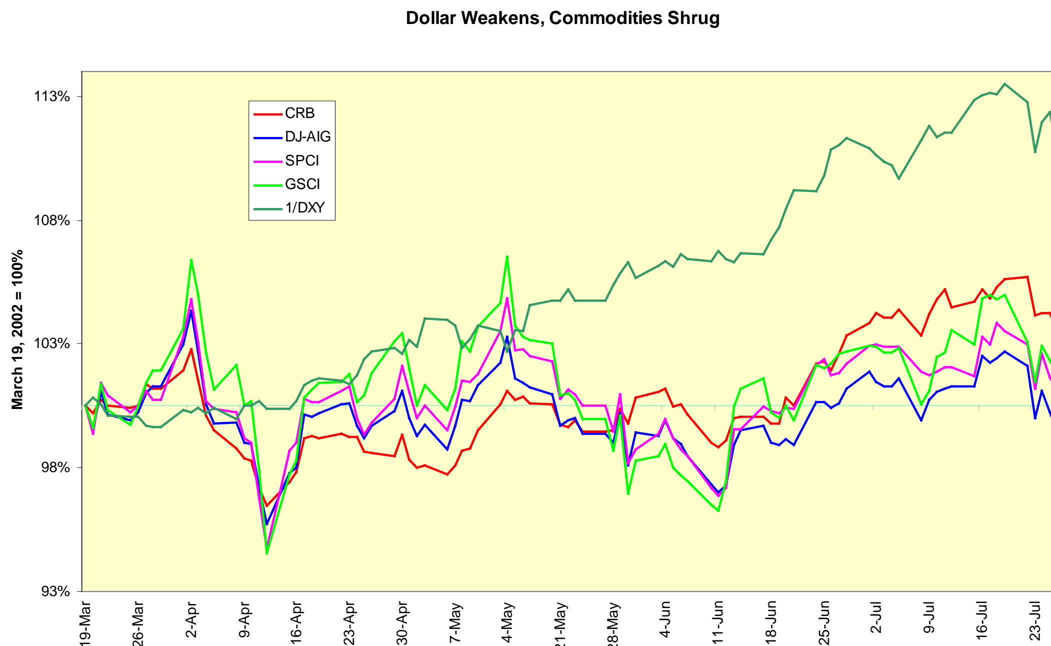


Suppose They Gave An Economy And Nobody Invested

This past January, I had nice things to say about silver stocks, and last October had advocated investing in assets such as high-yield bonds, commodities and emerging markets, asset categories that benefit from low interest rates and declining credit spreads. Indeed, high-yield has outperformed stocks since then, and we all know about the big spring rally in gold stocks and the relative resilience of emerging markets, particularly non-Japan Asia.

But by the end of May, the spread between inflation-indexed (TIPS) and nominal bonds started to contract and the gold rally started to stall. Yes, the dollar continued to weaken against the euro and especially the yen for a while longer, but nothing else signaled incipient inflationary pressures. Even the dollar's slide did not indicate an overly rapid increase in the money supply so much as a restoration to levels dictated by trade flows and interest rate differentials. It had levitated though a combination of stress elsewhere and a stubborn belief that asset returns in the U.S. still were greater than available elsewhere.

Commodity prices are now in retreat, which is even more astonishing given the effects of dry weather on the U.S. grain crop. Let's take a look at the movements of four different commodity price indices, those of the Commodity Research Bureau, Standard & Poor, Dow Jones-AIG and Goldman Sachs since the March 19th failure point in stocks.
In addition, let's overlay the inverse of the trade-weighted dollar index: A weaker dollar should, all else held equal, lead to higher commodity prices as you now need to use more dollars to buy the same amount of goods on the world market.



All else is not held equal. The weakness in commodities in the face of a weaker dollar suggests that either something is collapsing on the demand side or commodity buyers are faced with a lack of pricing power for their finished goods and need to bid commodities lower to maintain processing margins. As these two phenomena are not contradictory, both factors could be operating.

The Sum Of All Fears

Those who study history are condemned to quote it. In this case, we must cite the examples of the U.S. in the 1930s and the ongoing Japanese debacle. In these cases and others, an investment bubble led to overcapacity and a misallocation of resources. The burst led to huge frictional costs – when they talk about the $7 trillion or so missing in action since March 2000, where do you think that money went? – and a subsequent drop in both capital spending and final demand.

To-date, we haven't seen outright deflation. Its arrival has been postponed by one-time events like the housing boom; how many times can you refinance your house? Once this episode ends, and it will, we're going to have some tough decisions to make as a society. We know from our 1930s experience and Japan's mess that Keynesian public works won't stimulate aggregate demand; they'll simply transfer scarce resources to the politically favored. We know as well that both deflations and global currency regimes frequently end with catastrophic wars. No one wants one of these, but history is littered with them.

What should we do as investors? Deflation rewards creditors, not debtors. So, low-quality bonds, emerging markets and commodities should get the heave-ho from your portfolio. High-quality bonds and cash should stay (isn't it embarrassing that cash, yielding as little as it has, has outperformed stocks since 1997?).

And, in an odd twist, convertible bonds can do well in a deflationary environment as the recent Japanese experience indicates. Why is this the case? They can be a cheap source of initial financing for entrepreneurs who are both shut out of conventional bond markets and who are willing to part with some equity down the road.

After all, there's always a good idea somewhere looking for capital. That's kept us going before and will in the future.