



August 24, 2009

Investing in Inflation/Deflation

Inflation

We all have a general understanding of what inflation is and how it's caused. Quite simply, inflation is rising costs/prices. Too much isn't good and neither is negative. The Federal Reserve is happiest when it runs between 1 and 2% annually, though it has averaged 3% over the past 100 years. Over the past 30 years, the U.S. has experienced disinflation, a secular period of falling inflation rates. In 1980 the CPI (Consumer Price Index) peaked at 14.76% to fall to a low annual rate of just 1.55% by 1998, to once again peaking at 3.85% last year.

Deflation

Deflation is something that only a few of our client's have ever experienced. The last time the U.S. experienced real deflation was during the Great Depression years, when asset prices fell as much as 10.30% in 1932 alone and for the period of 1927-1933 prices fell more than 25%. Modern history gives us an example of deflation in Japan. Japan was left far behind as a world power over the past couple of decades, as their stock market lost 80% of its value top-to-bottom and real-estate values having been hit nearly as hard. It has been largely agreed that the cause of their deflation was the unwinding of huge leverage put on during the dual bubbles in both their stock and real-estate markets.

So why bring this up now?

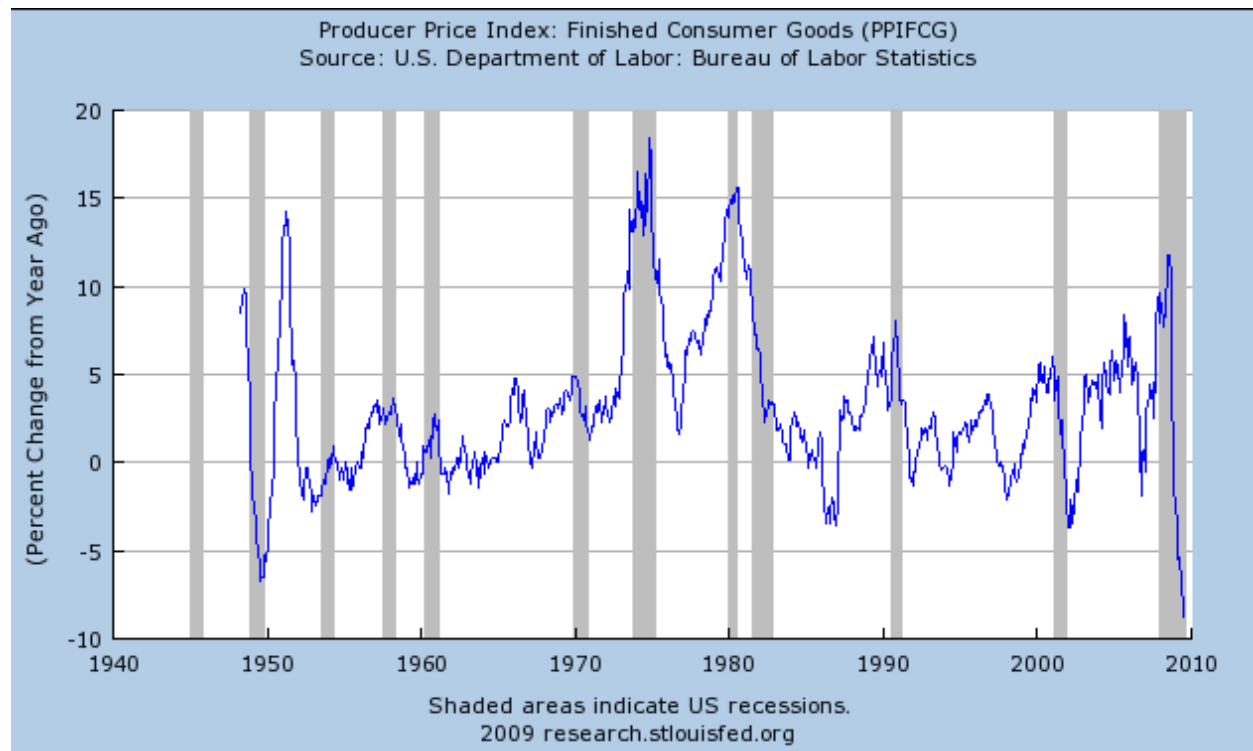
Today we see similarities in some parts of the world to what transpired in the early 1930's and more recently in Japan. Quite simply, as asset prices increased more debt leverage was put on and as the asset prices fall, leverage will have to be reduced. How do you reduce leverage? One of three ways, dip into your pocket and pay it back, sell the asset and pay it back, or default and through the court system be relieved of your obligation. We've already seen all three with the third method making the evening headlines. But, all three put downward pressure on the value of the assets. For the first time in nearly

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all of our lifetimes we are experiencing deflation. For the past five months for the period of March through July, we have had negative inflation numbers, with the largest decline just reported for July at a negative annual rate of 2.10% for the Consumer Price Index (CPI). And, on Tuesday of this week the Bureau of Labor Statistics (BLS) reported that the year-over-year Producer Price Index (PPI) for finished goods fell 6.80% (chart below).



Investing in inflation and selling deflation.

Some rules of investing are so simple. Yes, if you avoid countries experiencing deflation and focus on those with inflation, you should experience superior investment returns. To identify these, the inflation countries have low debt and sustainable growth, while the deflation nations have high debt with flat to negative growth. In some areas these differences are easy to spot and others harder. We've been a proponent of International investing for years and have enjoyed the international markets outperformance. But, the game has changed. Growth will be harder to find, but those that identify it will be rewarded richly. If you look at the category of Emerging/Developing Markets we can identify two of the distinct groups, Eastern Europe which has faltering growth with high debt and then the nations that surround the Indian Ocean with positive growth and almost no debt. The former should lag, while the latter should lead.

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How can some parts of the world have inflation and others deflation?

Over the past few decades, world prices rose and fell pretty much in unison with few exceptions, causing the world's central banks to raise and lower interest rates together. But, with some areas of the world deleveraging, things will be very different. A good way to think of it is with a question. If the average acre of land in the U.S. costs \$1000 today, and the average acre in India cost \$100, could the U.S. acre be worth \$750 and the Indian acre worth \$250 in 20 years?

This debt took 50 years to put on, and it's going to take time to take off.

Over the past year, we've witnessed world governments taking on debt as the private sector sheds it. This quantitative easing has stabilized the world markets, but can't go on forever. During World War II, the U.S. Government's spending reached 50% of the Gross Domestic Product to support the war effort. Today, without a war we're back to 50%. Government spending will have to move back to a more reasonable number, such as 30% GDP.

Now what?

We are not concerned about another financial system meltdown of the likes of last fall. Fifteen months ago as I wrote "The Wall Street We Once Knew", their average leverage was thirty-to-one, today for the remainder it's just eleven-to-one. But, the deleveraging will take time and a new way of thinking will be the one to thrive. The current bear market will mark a low that we'll never see again, but the world and investment environment are forever changed and a changed way of investing will prevail.

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