FirstPoint Financial

WEEKLY MARKET THOUGHTS

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Good Deflation

De ‘flaSH(e)n: the action or process of deflating or being deflated; reduction of the general level of prices in an economy.

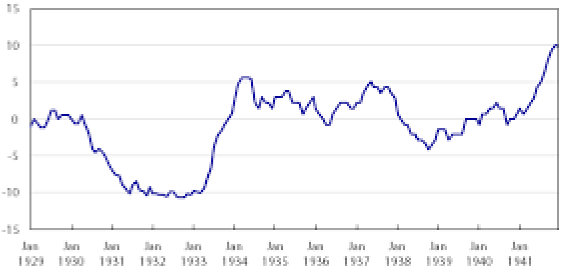
In past commentaries, I’ve written about deflationary pressures, a primary risk the world’s financial system faces. Inflation, a general rise in prices, occurred in the 1970’s and the early 1980’s. It wasn’t pretty, and it took a major economic contraction (1980 – 1982) for the world to work its way out of that period.

The last time the U.S. economy experienced a strong round of deflationary pressures was in the 1930s. Like inflation, deflation can be costly and difficult for an economy to shed. ***The economic pain inflicted by deflationary pressures includes loss of jobs and a lowering of overall economic production on a systemic, or long term, basis.*** Some say the only thing that brought the world out of the deflationary spiral of the 1930’s was the massive spending activity which occurred during World War II.

Deflation is measured by a decline in general prices, or negative inflation rates. During times of deflationary pressure, bond prices soar as the repayment of debt occurs with ever-more valuable dollars. In other words, if you owe a bank $100,000 today, and if general price levels fall by 10 percent, you’re paying the debt back with currency that could purchase 10 percent more in a year than is the case when the loan was made (this is before the computation of interest owed). Bond markets perform particularly well during times of strong deflationary trends. During times of deflation, it’s good to be a lender and bad to be a borrower.

Good and Bad Deflation

Figure 2. All-Items Consumer Price Index, 12-month change, 1929–1941



Source: U.S. Bureau of Labor Statistics.

The scenarios above paint deflationary pressures as a bad malady. Indeed, deflation tore the national economy apart during the Great Depression (see chart to the left which depicts inflation rates during the Great Depression years). The rate of inflation was -10 percent per year from 1930 until 1933; unemployment eventually peaked at 25 percent. That period of deflation was a result of the Federal Reserve raising interest rates, which led to a contraction in money supply at the time when the opposite policy was the proper action. The Fed starved the economy of money, which led to falling levels of aggregate demand and prices. Labor productivity fell from an annual growth rate of 5.44 percent in the 1920s to 1.95 percent from 1929 - 1937.

This wasn't the case in the late 1800s. That round of deflationary pressure was driven ***by a significant rise in overall economic productivity.*** Growth was occurring because the industrial revolution was gaining ground which, in turn, created lower manufacturing costs. This is an example of good deflation – a period which inspires investment and growth in consumption.

Which Form of Deflation?

It's up for debate on which form of deflation the world is currently experiencing. We're hard-pressed to find a major central bank currently conducting restrictive monetary policies, as was the case in the 1930s. With interest rates extremely low, the U.S. Federal Reserve, the Bank of Japan, the Bank of England and the European Central Bank (ECB) are all in the easy money camp. Additionally, Quantitative Easing (QE) strategies have been on-going in the United States and Japan. Recently, the ECB announced their own version of QE.

The unemployment rate in the United. States has been falling rather dramatically over the last five years. From its peak of 10 percent in 2009, unemployment has fallen to 5.6 percent in December 2014. On the other hand, Eurozone unemployment remains high. The latest read of 11.5 percent is down slightly from a peak of 12 percent in 2012.

Yet, prices remain stable. Consider the following recent data on inflationary trends in the developed world (data for the last 12 reported months):

G-20:	2.6 percent	**U.S.:**	.80 percent
Eurozone:	0.3 percent	**Great Britain:**	0.50 percent
Japan:	2.4 percent	**China:**	1.60 percent

Inflation is on its way out in many economies. While it isn't currently present in most large global economies, it's important to understand the following developments:

1. Deflation economists are focused on the decline in oil prices and other commodities***. For example, German "headline" inflation is running at -0.5 percent. However, excluding energy and food deflation, German "core" inflation is currently at .9 percent.***
2. ***The U.S. "headline" inflation is now at .8 percent, barely positive. If one simply excludes energy deflation of -10.6 percent for the last 12 months, inflation is actually at 2.05 percent in the United States. This is hardly a deflationary pricing structure.*** In fact, with oil prices falling, and gasoline prices falling in line with the oil price decline, the average family has basically received a massive tax cut over the last 12 months.

Productivity

The real issue is productivity growth. Productivity growth slowed dramatically during the deflationary years of the 1930s. The economy was in bad shape during that period. On the other hand, productivity growth, while spotty, was strong during the deflationary period of 1869 - 1879. ***During this period, GDP growth averaged 6.8 percent per year while productivity rose by***

4.5 percent per year. At the same time, prices (inflation) fell by 3.8 percent per year (estimates by Friedman and Schwartz). ***Consequently, history tells us that deflation, in and of itself, may not lead to overall economic contractions if productivity trends are robust.***

Current Productivity Trends

What do U.S. and European productivity trends currently tell us? Since 2008, real U.S. labor productivity has been rising an average of 1.8 percent per year (as compared to the long-term average increase of 2.2 percent since 1947). That's not bad, but also not great. On the other hand, European (17 countries) productivity has been rising by a scant .9 percent during this same period.

Our work tells us that Europe, more so than the United States, may experience damage to their economy's growth profile if indeed deflation is to take hold. While deflation would not be welcomed in the United States, Europe's growth problems seem to be systemic in nature – driven by poor demographics, a rigid regulatory environment and overbearing levels of government expenditure/regulation. The European markets appear to be a trade rather than a true investment opportunity.

Just for Fun

It's time to dust off the "January Barometer" theme. The "January Barometer," along with "Sell in May and Go Away," and "Don't Fight the Fed," are old Wall Street sayings which, by their nature, hold some statistical truisms. The "Barometer" was first discovered by Yale Hirsch at Stock Trader's Almanac. Basically, the "Barometer" states as January goes for the stock market, so goes the calendar year. If stock prices decline during January, then the odds are stock prices will decline for the year. If stock prices rise in January…well, you get the idea.

How has this theory worked out? Stock prices (the S&P 500 Index) have risen 52 of the last 71 years. That means stock prices, over an entire year, have been up 73 percent of the time. Pretty good odds. Stock prices in January were up 40 of 52 years. This suggests the "Barometer" was accurate in calling positive years 77 percent of the time.

What about negative years? The stock market has generated negative returns in 19 of the last 71 years, for a strikeout rate of 27 percent. Stock prices in January were negative in 14 of the 19 years. Thus, the "Barometer" was accurate in calling negative years 74 percent of the time.

The S&P 500 was down 3 percent this January…not a good sign for the year overall.

Now, what about that Super Bowl indicator…….

Corrections and Amplifications

In our piece from last week "Europe Goes QE," we misstated our intended comments in the 3nd to the last paragraph. Instead of saying: "Their desire is to lower the value of the Euro to the dollar, spurring overall export growth. On balance this didn't happen in the United States when the Fed was conducting QE operations over the last six years as the dollar tended to contract…."

My intended statement should have read: "Their desire is to lower the value of the Euro to the dollar, spurring overall export growth. On balance this did happen in the United States when the Fed was conducting QE operations over the last six years as the dollar tended to contract…."

We will be back next week.

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