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Schizophrenia, will it be inflation or deflation? September Newsletter

'The distribution of investors now has fat tails.' FT

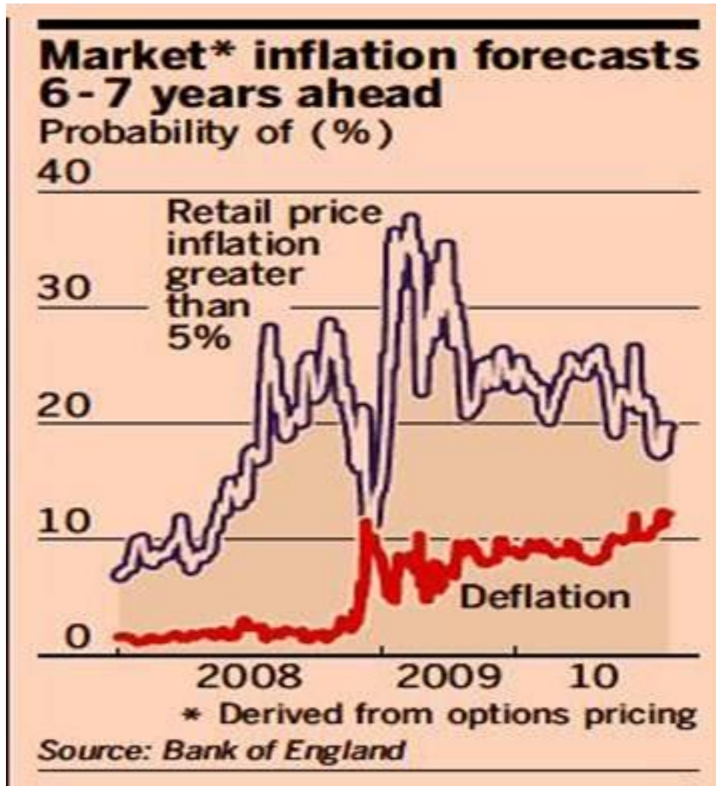
Key Recommendation – investors should take the opportunity to reduce fixed income exposure as markets fears over deflation become overblown.

Key issues – the market has become increasingly polarised amid concerns about possible deflationary or inflationary outcomes. Deflation is the least likely outcome.

Introduction

James Mackintosh published an article in the FT over the 21/22nd August weekend, explaining an unusual dichotomy in investors thinking. Investors seem to be squaring up into two distinct groups; the permabears and the gold bugs. These groups fear quite different outcomes. This can clearly be evidenced by the market for inflation and deflationary options. He commented:-

'back in January 2008, British investors thought there was less than a 10% chance that in six or seven years we would have either deflation or inflation of more than 5%. That combined probability now stands at more than 30%.'



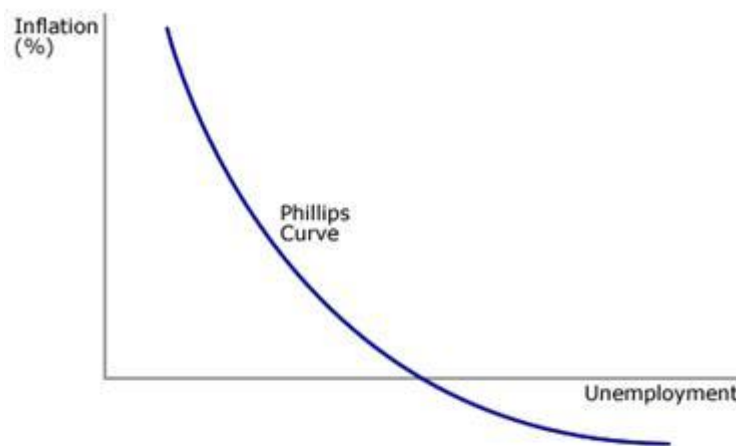
The **bears** fear that the bursting of the credit bubble has left the world economy lurching into a new world Kondratieff downwards cycle of debt reduction and flat growth. This may then mean with **too much spare capacity** chasing too little demand that a Japanese deflationary crisis is just around the corner.

Those concerned by **inflation** cite unprecedented central bank monetary printing, coupled with the cost push of commodities needed to keep pace with emerging economies. Furthermore structural problems could exist with the seemingly ever growing role of the state in western societies.

Deflation – could it happen? There are three basic causes.

1. The Output gap and a basic lesson in the Philips curve

It is an easily understandable fact that as a recession bites into demand, companies reduce payrolls and cut their capacity. This results in too few buyers for too few goods prompting market forces to pushing down prices. As unemployment rises inflation falls.



2. The Paradox of thrift

This term was first coined by Keynes to describe another understandable phenomenon. As people were either laid off, or feared that would be their fate they increased savings. This in turn decreased the amount of demand in the economy leading to further contraction, and hence the circle of reduced payrolls continued.

3. Inflationary or deflationary expectations

If we accept that recessions will reduce inflation, then it is another reality that as the populace will respond to what it sees as the likely direction in prices they adjust their behaviour accordingly. As prices may in fact fall, or at least rise very slowly, consumers will rein back purchases to get the best deals. This will have a knock on effect, and become another axiomatic depressant of demand.

Empirical Studies – so we know what to look for?

A recent paper prepared for the IMF (Still minding the gap, by Andre Meier August 2010) looked extensively, at in particular, the issue of 'persistent large output gaps' or 'plogs.' By taking data from over 25 historical episodes in advanced countries over the past 30 years some patterns can be identified.

The paper found that inflation tended to decline by about half from its original pre-recessionary level. However, in most of these cases there was not a further slide into deflation. The study showed four trends to support this view:-

1. An anchoring of inflationary expectations around a central bank target. This works both ways in helping to prevent runaway expectations of price increases and at the same time giving support to price stability on the downside.
2. As inflation has become more muted in recent decades, price changes have become less frequent. This leads to nominal rigidities.
3. Globalisation has made all advanced economies less dependent on domestic supply/demand equations, and hence part of a global environment. Hence the pressures from 'plogs' or other demand shocks no longer have the same impact.
4. Just how big is the output gap? This is a notoriously difficult subject to measure, and it has been noted from previous cycles that initial estimates were well wide of the mark.

This allowed Meir to conclude' disinflation has tended to taper off at very low positive inflation rates.'

Deflation reality -- what about Japan?

James Mackintosh writing for the FT's 'The Short view' explained the problem.

'Japan's lost decade is being nervously eyed by investors. Americans and Europeans are searching the data for clues to the pain to come if the debt-mired west falls into deflation.'

There is no doubt that Japan has suffered from deflation. It's not that the government was sitting idle, as fiscal spending has long ago tried to support the economy. Interest rates have been at near to zero for 15 years.

However, it may be that the very nature of Japanese society is different to those of other advanced economies. Demographic issues are of paramount importance, with the Japanese nation ageing fast. With virtually no immigration to top up this time bomb the total pool of consumers is already falling as the population stagnates.

For Japan's legions of ageing investors it may be that price stability is not such a bad thing. After all it is inflation that is so devastating to savers.

Inflation – 'is always and everywhere a monetary phenomenon.'

This quote is from Milton Friedman's seminal book, 'A Monetary History of the United States 1867-1960', and should still be at the centre of any analysis of inflationary expectations. In its simplest form Friedman argued that the creation of money, especially fiat, without corresponding increases in productivity, would spill over into higher prices. This theory still holds good.

In the 1980's when monetarism was at its zenith, investors waited excitedly for each week's M3 data from the Fed. Markets would then move on these figures. Now this data is barely glanced at, so has Milton Friedman any relevance in today's modern economy?

The velocity of money

The father of modern economics Paul Samuelson explained,' In terms of the quantity theory of money, we may say that the velocity of circulation of money does not remain constant. 'You can lead a horse to water, but you can't make him drink.' **You can force money on the system in** exchange for government bonds, its close money substitute**; but you can't make money circulate** against new goods and new jobs.' (Wikipedia)

There are two issues at work here. Firstly, the increased sophistication, and indeed size of the financial sector has lead to a proliferation of instruments and hence the faster circulation of money in the economy. For instance the re-packaging of mortgages means that those assets are no longer sitting on a bank's balance sheet, rather they were re-sold and became live again.

Secondly, during periods of recession it is not surprising that money tends to 'stick'. Consumers, banks and companies are not in a hurry to spend any surplus cash.

If money moves more quickly around the system, then it is bound to have more of an effect on prices.

Money Supply – some conclusions

The Federal Reserve writes a regular publication entitled, 'Monetary Trends.' In September's issue David Wheelock asks in reference to the explosion of the Fed's balance sheet, 'Why was the increase in the money stock so small when the increase in the money stock was so large?'

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After the Fed purchased some $1.7trillion of securities it would have been expected that this would have fed through into monetary growth. However the sharp slow down in velocity of circulation has meant that little has fed through into the economy.

But it does not mean that this liquidity is not out there and can be deployed. An analysis of the Fed's balance sheet provides an answer. Prior to the crisis, commercial banks used to re-circulate the vast majority of their surplus funds via the inter-bank market. But when the credit crunch started to bite, the attraction of parking funds at the Federal Reserve has assumed a great significance. Accordingly since 2005/6/7 these reserves have ballooned from a steady mid 90s billion $, to a mighty 1.158 trillion $ in the second half of 2010. (Federal Reserve website).Its understood that this is partly a product of poor loan demand, but those funds are their. Slow monetary circulation should improve over time adding impetus to deployment.

The conclusion being this increase in monetary availability is sitting on call, and can be deployed at any time in the future. We should not ignore it.

Conclusion – Bond bulls are playing with fire

Brian Dennehy, of Dennehy Weller 'the party is over in corporate bonds – honestly it is.'

A thirty year bull market started with 10 year treasuries at a whopping 16%

With the same 10 year risk, investors are only getting paid a paltry near 2.7% The Fed has been behind much of the recent move, not only in being a large buyer of bonds but also telegraphing a desire to see the yield curve flatten.

Before we finish this piece it might be worth picking up on some pre-crisis views when minds were perhaps a little less jaundiced by the heat of the moment.

Writing from the vantage point of April 2007, Fed governor Frederic Mishkin helped us with some musing on how much the Central bank could really achieve. Firstly he reminded us about that the Phillips curve in citing that ‘a temporary trade off between the two mandates (inflation and employment) may exist.’ (Source: Fed reserve Website.) However, he was equally quick to point out the limitations of such policy.

‘Any attempt to use a stimulative monetary policy to maintain employment above its long run sustainable level will inevitably lead to an upward spiral on inflation.’

This seems exactly where we now are.

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