August 23, 2010

The Week

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Strategies for deflation and inflation

Many investors are increasingly worried about deflation. We continue to believe that modest inflation, not deflation, is the most likely scenario going forward. Nevertheless, it may be useful to examine alternative strategies for deflationary versus inflationary environments.

Many people learn first aid and CPR in case they are ever confronted with an emergency and need to aid or resuscitate someone. Fortunately, most people never have to use CPR. However, it is good to know what to do if needed. As the boy scouts say, it is good to be prepared. This holds true for investors. Most of the time, the U.S. economy expands, allowing investors to profit from owning the equities of growing companies. However, a different set of investing strategies may be appropriate during deflation than during inflation.

Deflation is rare but not unheard of in a modern economy. True deflation, when consumer prices and asset prices decline, usually only happens when the economy is in a severe recession and credit dries up, forcing people to sell assets at distressed prices to raise money. The U.S. economy experienced a short period of deflation during the recession and financial crisis of 2008 and early 2009. Fortunately, the Fed was able to provide extra liquidity to the financial system during that period. In fact, the Fed pumped so much money into the economy that investors started to worry about inflation rather than deflation.

History shows that investors are much more familiar with inflation than deflation. During inflation, consumer prices and asset prices increase because people and companies have money to spend and they bid up prices for the goods or resources that they want. There have been many more years of inflation than deflation since the United States went off the gold standard in 1971, because the U.S. money supply is no longer constrained by the quantity of gold backing the currency.

Markets tend to move in anticipation of inflation and deflation. Therefore, investors should look at inflation expectations rather than actual inflation or deflation. But even this distinction may not be sufficient to differentiate the appropriate strategies. Consequently, investors should also consider whether the economy is growing or not growing when inflation expectations are rising or falling. Making this added distinction presents four alternative scenarios that create four different strategies for investors. Finally, before looking at these four scenarios, it is important to point out that all of the markets may not move as indicated all of the time in each of these four categories. However, we believe that these are the most likely outcomes in these situations.

It is necessary to distinguish between a situation where the economy is expanding versus contracting because stocks are likely to be influenced by prospects for expanding profits in addition to increasing or decreasing inflation expectations. On the other hand, the state of the economy is probably not as important for bonds. Instead, rising or falling inflation expectations seem to be the driving factor influencing the direction of the government bond market. The same is true for the dollar, assuming there are no major differences in economic performance between countries. Finally, commodities tend to rise and fall along with rising and falling inflation expectations, regardless of whether the economy is strong or weak. Putting all these considerations together produces a matrix of four different scenarios that are most likely to prevail in the four alternative situations.

The upper left hand corner of the four-squares is the environment where investors are most concerned about recession and deflation as they are now. In this situation, investors seeking safety tend to move toward government bonds and the dollar and out of stocks and commodities. This is what happened in 2008 and early 2009 and again this past spring when fears of a double dip grew.

The lower right hand corner of the four squares is the environment where investors are most concerned about inflation. In this situation, investors seeking a hedge against rising prices

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tend to favor stocks over fixed-income securities. At the same time, rising inflation expectations tend to hurt the dollar but boost commodity prices.

The lower left hand corner is the scenario that tends to be best for financial assets and worst for commodities. In this situation, the economy is growing and inflation expectations are declining. This is good for stocks, bonds and the dollar but bad for commodities. This was the environment that prevailed through much of the late 1990s. Commodity prices did not do well at that time because inflation concerns were receding as the dollar rallied.

Finally, the upper right hand corner is the scenario that can be very good for stocks at the end of a recession as the Fed pumps a lot of money into the financial system to boost economic growth. Stocks tend to be helped more in this situation by the easy money and rising inflation expectations than they tend to be hurt by the recession. This is what happened a year ago when fears of inflation increased even though the economy was still deeply depressed. In this case, investors moved back into stocks and tended to shun government bonds and the dollar. However, commodity prices started to strengthen.

INFLATION EXPECTATIONS DECLINING, ECONOMY WEAK OR CONTRACTING Government bonds – strong Stocks - weak Dollar – strong Commodities - weak	INFLATION EXPECTATIONS RISING, ECONOMY WEAK OR CONTRACTING Government bonds – weak Stocks – strong Dollar – weak Commodities – strong
INFLATION EXPECTATIONS DECLINING, ECONOMY HEALTHY AND GROWING Government bonds – strong Stocks – strong Dollar – strong Commodities - weak	INFLATION EXPECTATIONS RISING, ECONOMY HEALTHY AND GROWING Government bonds – weak Stocks – strong Dollar – weak Commodities – strong

Past performance does not guarantee similar results, and all markets may not move as indicated in all situations.

This analysis focuses on inflation expectations rather than actual inflation or deflation because that is the focus of the Federal Reserve when setting monetary policy. Fed officials often judge inflation expectations by watching the markets. When government bonds are strong, stocks are weak, the dollar is strengthening and commodities are weakening as has occurred recently, investors believe the economy is weak and inflation expectations are decreasing. That is when policymakers tend to talk about providing extra monetary stimulus in order to dampen deflation concerns. Of course, the Fed may not need to do anything unless actual deflation develops.

In summary, the four scenarios in this analysis can guide strategies during periods of rising and falling inflation expectations. However, past performance does not guarantee similar results. In addition, the markets will not always move as indicated in these situations. Nevertheless, this analysis may be useful for investors who want to be prepared in case any of these situations develop. We believe the markets are likely to transition to the scenario in the lower right hand corner as the economic recovery matures. However, the markets are currently performing similar to the upper left hand corner where inflation expectations are declining because economic growth has slowed and investors are concerned about a possible double-dip recession.

Important Information, Risk Factors and Disclaimers:

- Past performance is not a guarantee of future results.
- Diversification does not guarantee a profit or protect against loss.
- Investing in fixed income securities involves certain risks such as market risk if sold prior to maturity and credit risk, especially if investing in high yield bonds, which have lower ratings and are subject to greater volatility. All fixed income investments may be worth less than the original cost upon redemption or maturity. Bond prices fluctuate inversely to changes in interest-rates. Therefore, a general rise in interest rates can result in the decline of the value of your investment.
- Buying commodity based investments allow for a source of diversification for those sophisticated persons who wish to add commodities to their portfolios and who are prepared to assume the risks inherent in these markets. Any investment represents a transaction in a non-income –producing commodity and is highly speculative. Therefore, commodities should not represent a significant portion of an individual's portfolio.