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Is it Inflation or Deflation?

There is no shortage of data to evaluate the prospects for inflation or deflation. Economists, scholars, bankers, journalists and politicians issue opinions and forecasts that have offered little constructive guidance.

During most of the past three years, a period now described as the great recession, the consensus has consistently projected rising inflation and tighter monetary policy as a result of extraordinary deficits and government spending. As is often the case, the consensus has been proven wrong. Instead of interest rates rising in the second half of 2010, as most Wall Street firms and economists predicted in 2009, the opposite has occurred. In fact, the Federal Reserve is buying long-term bonds to keep yields down and is maintaining a low short-term interest rate policy. With the exception of rising commodity prices, (e.g. metals, energy, food) consumer prices have fallen during the past three years, as you might expect during a period of falling aggregate demand.

With the Federal Reserve concerned about the absence of employment growth, it is witnessing another looming problem – deflation. The evidence is found in recent Senate testimony by the FDIC that as many as 850 U.S. banks may fail in the next 24 months. This is because the underlying collateral of troubled banks has fallen in value in recent years, which is deflation of commercial and residential properties. The Federal Reserve is attempting to ignite a new phase of inflation, which requires an increase in aggregate demand of labor, materials, food, energy and pricing power.

Labor
The global economy allows labor costs to compete across borders. During the 1970's, rising labor costs in the U.S. were a significant factor in the high inflation rate. Today, manufacturers and service companies operate where labor costs are lower. Automation remains a significant competitor to labor.

Materials
As the cost of steel and aluminum rises, engineers change designs to reduce input costs. In order to manage its cost of materials, China has entered into long-term supply contracts for coal, iron-ore, aluminum and petro-chemicals; along with generous capital investment terms. This is exactly what Japan did during its economic boom (1970 – 1990).

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Food
Demand for proteins and carbohydrates, during the past five years, is the result of a growing middle class among the developing countries. Accordingly, this category has been a cost inflator. As Brazil has expanded its food exports to meet the growing world demand for food, the U.S. farmers are finding higher profits growing cotton and corn. But tax credits encourage corn-based ethanol, not food exports.

Energy
In real dollar terms, the cost of oil, gas and coal has not increased since the 1970's. Electricity is generated primarily from coal, nuclear, hydro and natural gas. Transportation costs are highly correlated to the price of oil, but improving efficiencies have reduced real costs. In 1980, it was predicted that world oil supplies would be exhausted by 2012. Technology continues to uncover new prospects throughout the world. In fact, the recently publicized BP discovery in the Gulf of Mexico may be one of the largest in the U.S. since Prudhoe Bay in 1967. Barring a major disruption of oil supplies, energy costs will not be a cost inflator for the foreseeable future.

Pricing Power
The ability of companies to raise prices is pricing power. As global competition has grown, real prices for products and services have fallen, with the exception of non-generic drugs and complex military hardware. In the U.S., apparel retailers sell low cost imports. The prices for home entertainment devices and computers decline each quarter. While a falling dollar value might cause concern, both importers and exporters use forward exchange rates contracts to manage this uncertainty.

Prospects
Recent monetary and fiscal stimulus among the major central banks has been historic in magnitude. But unlike the many inflationary and several deflationary periods of the past, the macro environment today has set in motion a possible prolonged period of low to modest inflation. Inflation will be more pronounced in the developing and emerging markets where aggregate demand is still more localized. In the developed world, (e.g. U.S., Japan, Europe) non-food inflation will be well below the 50-year trend.

Investment yield is attractive during periods of low inflation. This is true since the real buying power of current income is preserved. However, the current bond yield among the highest quality issuers is very low. In fact, not since the 1950's have stock dividend yields been so attractive relative to bond yields. In addition, lower bond yields mean more favorable borrowing costs and a stronger balance sheet – a good formula for future stock performance.