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"Deflation Anxiety"

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There are many signs that the US economy has started moving from an inflation based economy to a deflation based economy. This will require a major attitude adjustment for many Americans, particularly those under the age of 65. Long-held assumptions regarding how the economy works and how people should run their financial lives are coming under question. I call it "deflation anxiety".

Deflation is defined as a decrease in the general price level of goods and services. Deflation occurs when the annual inflation rate falls below zero resulting in an increase in the real value of money – allowing one to buy more goods and services with the same amount of money. Deflation is correlated with recession and discourages investment and spending because there is no reason to invest when the expectation is that future prices will be lower. The typical cause of deflation is a contraction in the supply of credit provided within an economy. Severe deflation can help cause an economic depression.

Deflation anxiety is very stressful because the phenomenon is outside of our recent American experience. For many of us, we've only seen inflation rather than deflation, even during recessions. The cumulative inflation rate experienced by a typical 60 year-old person from 1949 to 2009 is 803% or an average compounded rate of 4.3%. The purchasing power of one dollar tucked under the mattress in 1950 is now worth 12.5 cents. Just remember the increase in price of postage stamps over our lifetimes!

During periods of long term inflation Americans have internalized core assumptions on how to manage money, spending and investing. These assumptions make you feel better and cover up poor decisions. For example:

- Borrow now because you can pay off the loan in cheaper dollars later;
- Buy now because the price will only go higher;
- Real estate and fixed asset values always go higher over time;
- Your salary will typically increase – 3% inflation adjusted raises.

The assumptions listed above are imbedded in the psyche of most Americans under the age of 65. However, many over age 65 remember that inflation was not always the assumed business case. For example, from 1920 to 1950 the cumulative inflation rate over 30 years was 21.8% or less than 0.8% compounded per year. During this time period, individuals managed their money using different principles.

For example:

- Credit cards and "lay-away" plans were despised – austerity was the norm;
- People held off "buying now" because prices usually go down;
- Only buy on sale – never pay full retail;
- Postpone buying until times improve;
- Real estate was considered consumption, not an investment;
- You were lucky to have a job – annual inflation raises were not expected.

The Record of Deflation in the U.S.

Deflation typically correlates with periods of recession. For the first time in over fifty years, the United States experienced deflation in 2009 when the CPI index grew at -0.34%. As of June 2010, the current inflation rate is 1.05%. Since 1914 periods of deflation occurred in the following years:

1955	-0.28%	1932	-10.30%	1928	-1.15%
1949	-0.95%	1931	-8.94%	1927	-1.92%
1939	-1.30%	1930	-2.66%	1922	-6.10%
1938	-2.01%	1929	0.00%	1921	-10.85%
1933	-5.09%				

Mild Deflation

Mild deflation or "no-flation" is much more common than severe deflation. With mild deflation prices are stagnant and economic activity moves at a slower pace. Once people adapt to having no inflation, the economy can grow normally. Under severe deflation, a vicious spiral of cost cutting and asset sales perpetuates itself for several years resulting in value destruction and economic contraction. This is what occurred in the U.S. in 1930-1933.

The U.S. is currently in a period of mild deflation. The economy is growing at a rate of 1% to 2%. Inflation is now down to 1.05% and declining. Bond yields that used to be 5% are now 2.5%, and provide the same real rate of return. Stock returns that expected to provide 9.5% growth are now 6.5%, but are technically equivalent. Even though the real returns are equivalent, I felt better off when we had mild inflation!

Ben Bernanke, the head of the Federal Reserve, is acutely concerned about the negative impact of deflation on the United States and is committed to creating money to stop deflation from occurring here. While we believe Ben Bernanke strategy is correct, it cannot succeed without responsible fiscal policy action requiring short-term stimulus and long-term cost containment. Hopefully, our political parties can stumble into a successful solution.

Investing During Deflation

Academically speaking, stock market returns have 3 components:

1) Implied Rate of Inflation
2) Risk Free Rate
3) Equity Risk Premium

The expected rate return is the sum of these three components. Currently, the bond market is pricing-in an implied 5-year inflation rate of 1%. Historically (over 84 years), CPI inflation has averaged 3.1%; the long-term risk free rate of return is about 0.7%; and the equity risk premium is about 4.8%. If the bond markets view of 1% inflation is correct, the theoretically expected rate of return of stocks is 6.5% annually over the next five years.

This may seem surprisingly low to some who recall long-term rates of return for stocks in the 9% to 11% range. However, recent inflation from 1956 to 2007 averaged 4%. In a higher inflation environment, the sum of the three expected return components would total 9.5%.

Historically, large cap stocks perform well during periods of mild deflation or no-flation. Since the 1920's, the U.S. stock market was meaningfully higher after a quarter of mild inflation or mild deflation. The bad news is, during periods of severe deflation, -2.5% or more annually, the stock market performed very poorly and the best asset to hold was long-term U.S. treasury bonds. With inflation currently running at 1%, we are hoping that historical trends prevail.

During periods of deflation, residential real estate is considered consumption not investing and should increase at the rate of inflation. Residential real estate only makes sense to purchase if it is cheaper than the cost of renting. The problem is that it may take several years for prices to decline to reach fair value levels. Once prices adjust, real estate would be considered an average long-term investment with extra upside potential if inflation returns.

Conclusion

Deflation is no fun and can create substantial personal anxiety, particularly when trying to adjust from a long-term inflation based world. Mild deflation or zero inflation will not destroy your standard of living; it will just make you feel less well off. The keys to success are:

- Cut your expenses annually;
- Reduce your fixed debt costs;
- Keep a secure job or business;
- Enjoy what you have now;
- Invest for the long term and stay diversified.

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