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By Valentino Sy

Inflation, Deflation, Reflation

What a difference a year makes. Twelve months ago, investors were worried that surging inflation due to high oil prices has exacerbated the slowdown in the global economy which at that time has already been weakened by the US sub-prime and credit crises. Six months later, the concern has turned from inflation to deflation as deleveraging, falling asset prices, rising unemployment, declining wages ensued after the collapse of Lehman Brothers.

Now, deflation appears to have been defeated. In fact, the huge run-up in stocks and commodities since March indicates that the policy-induced reflationary efforts (courtesy of the Fed and global central banks) are gaining the upper hand.

This article is part of our continuing investment basics series. We will attempt to introduce the concepts of inflation, deflation and reflation to new investors. At the same time, we will also give advice on what investors should do to their portfolios when faced with such scenarios.

Inflation

In economics, inflation is defined as a continuing rise in the general price level of goods and services usually attributed to a relative increase in the volume of money and credit. In general, inflation is not necessarily bad. It is usually driven by strong economic growth.

High and unpredictable inflation, however, is bad for the economy due to the following reasons:

- Rising inflation can induce a wage-spiral when workers demand higher wages to maintain their standard of living.
- Uncertainty about the economy may discourage savings, especially if real interest rates are negative.
- Uncertainty about the future makes business planning and budgeting difficult.
- Higher prices of raw materials, energy and other inputs can squeeze margins which can then feed through business investment decisions.
- Inflation reduces the real value of fixed income, thus affecting pensioners who rely on fixed pensions year after year.

For stock investors, high inflation is bad because it devalues corporate earnings, a major driver of stock prices. Furthermore, inflation is usually accompanied by a rise in interest rates which is bad for stocks. A higher interest rate effectively removes excess capital in the markets. In a high inflation environment, investors are better off investing in hard assets (like gold, oil, other commodities) and Treasury Inflation-Protected Securities.

Deflation

Deflation, on the other hand, is the opposite of inflation. It is a decrease in the general price level of goods and services. Deflation can be induced by negative shocks to aggregate demand and is damaging to the economy because of the following reasons:

- Falling prices of goods can lead to a "deflationary spiral." As prices of goods fall, consumers delay their purchases and consumption to avail of lower prices, thereby reducing overall economic activity. Lower capacity usage leads to less investments going forward, further cutting down economic activity.

- Deflation leads to a reduction of credit, deleveraging, fall in asset prices (asset deflation), fire-sale of assets, and further reductions in lending (debt deflation), which ultimately affects economic growth.
- The collapse of aggregate demand due to deflation is usually associated with recessions and quite possibly long-term economic depressions.

If high inflation is bad for stocks, a deflation caused by a fall in aggregate demand is a nightmare. During these rare instances of deflation, the stock market collapses. It happened in 1929 to 1934 in the US and 1988 to 2005 in Japan. We've also had a glimpse of it when markets around the world went into free-fall in the 2nd half of 2008. In a deflation, there are only a handful of places to hide: gold, treasury bonds, the US dollar and the Japanese Yen.

Reflation

While inflation and deflation are both market-driven, reflation is an intentional, policy-induced economic phenomenon. Reflation is driven by government policies, usually by using inflationary measures (e.g. public spending, tax cuts, monetary easing, quantitative easing), to reverse deflationary trends. Today's environment is characterized as such: a raging battle between deflationary forces and government's reflationary policies.

Reflation vs. Deflation - Who's winning?

At the start of the year, we predicted that the global economy will start to stabilize in the 2nd half of 2009. We also said that "*we expect the policy-induced reflationary efforts to offset the credit-led deflation* (see *2009: A Year of Opportunity* in the January 12, 2009 issue of **The Philippine Star**)."

In another article, we disagreed with most foreign houses calling for $25 oil (Merrill Lynch) and $30 oil (by Morgan Stanley and Goldman Sachs). We mentioned that "*if the inflation scare comes back in a few years, it is not far-fetched to see oil trading above the $100 per barrel level again* (see *Crude Oil: Forming a Bottom* in the March 2, 2009 issue of **The Philippine Star**)." Since then, Goldman Sachs has reversed and just last week is now calling for $85 oil for end-2009 and $95 oil for end-2010.

Our prediction seems to be coming true. The surges in the oil, commodity markets and world stock markets, plus the decline in the US dollar appear to be symptoms of reflationary forces gaining the upper hand (see chart below).

Dow Jones World Index vs. Crude Oil, CRB Index, US dollar index (1-yr chart)

Source: Stockcharts.com

Hence, an investor betting in favor of reflation should continue to sell short treasury bonds. One way to do this is to buy the exchange-traded fund TBT (Proshares Ultrashort 20-yr Treasury bonds). On substantial pullbacks, one can also add metals, oil, and agricultural commodities to his portfolio.

With regard to equities, an investor could also add to their holdings on substantial pullbacks as they should perform well in a reflationary environment, especially emerging market stocks.

As mentioned in previous articles, we believe that the market has turned from a bear market to a budding bull market. Therefore, one should buy on dips whenever there is a considerable pullback or correction in the market. This is directly opposed to selling on rallies during bear markets.

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