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Where's the Fire? The Inflation vs. Deflation Debate Heats Up

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By Debbie Carlson

Two years after the credit crisis pushed most of the world into a recession, economists and market watchers are trying to anticipate where the U.S. economy will head in the coming months and years.

The stimulus plan unleashed by the U.S. government in 2008 and a near-zero interest rate monetary policy helped to stabilize financial markets. Earlier in 2010, positive economic data such as growth in manufacturing data and a pickup in auto sales helped the major stock indexes post sharp gains, signs the stimulus was having its intended effect.

That growth, along with a massive stimulus plan by the European Union and the International Monetary Fund, had classical economists suggesting all this liquidity would lead to future global inflation.

But by summer, the U.S. economy hit a soft patch, which has given many in the financial community pause, and the specter of slower growth—if not a double-dip recession and deflation—started to elbow out worries of rising prices.

WHICH PATH?

Now the debate is between whether the U.S. and the rest of the world is headed into deflation or inflation, and those who argue either side will use the same news and data to bolster their belief, leading to some confusion.

But these are nuanced arguments, not simplistic matters, so it should not be surprising that both sides can be correct in their assessments.

"There are a lot of contradictions out there, but as the great American writer F. Scott Fitzgerald says, the test of a first-rate intelligence is the ability to hold opposite ideas in their mind and to retain the ability to function," says Michael Szenberg, distinguished professor of economics at Pace University's Lubin School of Business in New York.

Deflation is defined as a sustained fall in prices, while inflation is a sustained rise in price, Szenberg says.

It is possible to see both inflationary and deflationary impacts in one movement, economists say. For instance, the joint European and IMF stimulus program announced in May, which included nearly €1 trillion in aid from various sources, is considered inflationary because of the idea that the government is essentially "printing money."

When the Federal Reserve lowered U.S. interest rates to near zero, it then practiced what was called "quantitative easing" by purchasing Treasuries to add liquidity to the market.

INFLATION RISKS

Because the world uses fiat currencies, there are risks of flooding the world with cheap money to inflate asset prices. But that is a longer-term concern once the economy is growing and when there is demand for goods.

In addition to the stimulus program, the goal for Europe is also to impose austerity programs once its economy stabilizes, which would include paying down debt. Money used to service debt does not go into the economy; it reduces demand and thus is deflationary.

IT'S ALL IN THE TIMING

These seemingly opposite views come from different schools of thought, but ultimately both are focused on timing, says Fariborz Ghadar, director of Penn State's Center for Global Business Studies and a professor of global planning and policy.

The first school of thought is the Keynesian view, as advocated by John Maynard Keynes, the British economist. To stabilize the economy, the government spends a large amount to create jobs. People get jobs, they start producing, the economy takes off, tax revenues roll in and that pays for the spending, he says.

THE FLIP SIDE

The classical school, also known as the monetarist view, is to let the market work it out. If jobs are not created, then money was spent and tax revenues would not pick up. The government has to borrow, affecting its credit rating, raising borrowing costs. In a worst-case situation, the government's currency becomes devalued and the country defaults.

"So to get it right, it's a question of timing. You don't want Joe and Nancy without jobs, and [at] the same time, you don't want to spend so much that the credit rating is hurt. The trick is to spend right now, have the economy get into OK shape, then pull back on the subsidies," Ghadar says.

Having the government flood the economy with money to create jobs and get people spending, then withdraw the stimulus fits in with Keynesian thought, says Lall Ramrattan, instructor at the University of California, Berkeley extension.

During the Great Depression, people kept money under their mattresses and did not spend, which Keynes called the "liquidity trap." The government then would provide the initial liquidity and remove it when people started spending.

The problem is some people do not trust the government to get the timing right. That is what's causing the current turmoil.

THE CONCERNS

"Governments aren't good at doing that, at the timing," says Brian Knabe, financial adviser and certified financial medical planner, at Savant Capital Management, a fee-only wealth management firm.

He believes that the U.S. bailouts and the stimulus were "necessary evils" to prevent immediate deflation and ultimately had a positive economic impact here. However, the amount of debt the U.S. took on to do these packages and the deftness of the government to get it right is what scares many investors.

"In the U.S., to cut the deficit, there will be slow growth, inevitably taxes will go higher, but you can't tax your way out of it. You'll need to cut budgets to rein in deficits to lower the debt and pull the lever back on stimulus," he says.

SHORT-TERM WORRIES

In the short term, it is deflation that is worrying market watchers, especially as the U.S. is struggling to produce growth. In July, minutes from the Federal Open Market Committee meeting echoed these slow-growth concerns.

Furthermore, there are concerns that if the global economies are starting to grow, hitting hard on austerity programs—i.e., pulling back the stimulus programs prematurely and cutting debt—could just as easily derail nascent growth.

"You don't cut debt during a recession. Deficits come down because of growth in the economy," Ramrattan says.

Shawn Hackett, president of Hackett Global Advisers, says the contraction of credit and the amount of debt globally—not just in the U.S.—is adding to deflation fears. He says the U.S. is likely heading for another deflationary period, but afterward that will set off huge inflation.

"The Fed is printing as much money as it can, but credit is decreasing. That's deflationary. Until this credit contraction cycle is over, it's impossible to see inflation," he says.

John Lekas, CEO of money-management firm Leader Capital, believes deflation has a hold on the U.S. economy now. "The problem is not tight supply, it's tighter money. It's a different environment. The dollar has moved down, but commodity prices have not moved up. That's a lack of demand period. Credit is getting tighter, things get more expensive, credit lines are more expensive, and people confuse inflation with that," he says.

Ramrattan says the lack of bank lending is what makes 2010 different from the Great Depression. "The banks are holding on to the money, so you have an institutional liquidity trap. It's not like anything else in history. Finding a solution to this problem could take a new economic idea. ... You'd probably get a Nobel Prize for that!"

MORE DOWNSIDE IN YIELD

Lekas says he expects the 30-year Treasury bond yield to continue to decay because he does not believe the U.S. economy is growing, despite that the first-quarter real gross domestic product reading showed a growth of 2.7 percent

He forecasts that the yield on the 30-year Treasury bond will be 2.75 percent by second quarter 2011, versus a yield in July of around 4 percent. If that is the case, he says, mortgage rates would fall further, and that might be enough to spur banks to loan money. "That's when we'll see buying in housing," he says.

The losses in the stock market could continue, and he projects the Dow Jones Industrial Average at 5,500 at that time.

If, as Hackett and Lekas suggest, the U.S. is in or heading to a deflationary environment, the historical way of exiting this cycle is to extend credit. But that's really not viable in this scenario.

Lekas says that prices must fall in the U.S. to allow it to compete globally. "We'll see standards of living go down. Is that such a bad thing? No. Wages have to come down. And if wages come down, it can incite real GDP growth, which is to knock down expenses," he says.

IT'S A DEBATE

Szenberg says the worries about U.S. deflation are overblown because it is not really accurate to say that the U.S. has seen actual deflation. The inflation gauge Consumer Price Index fell slightly during April, May and June on a seasonally adjusted basis, but the core rate (minus energy and food prices) was flat to slightly up. As of mid-summer, the index increased 1.1 percent over the previous 12 months before seasonal adjustment.

"We can't say we have it. It's interesting that the only decline in prices we see are Treasury bonds. We're not seeing consumer prices decline. The same can be said about car sales, car loans, credit card rates," he says.

Hackett says one sign that the U.S. is returning to growth is to see the contraction in credit ending. For that, he says look at the money supply multiplier effect to take hold.

Right now, the U.S. is seeing a negative multiplier effect—where the Fed prints money and credit shrinks. However, once the M2 data, released weekly by the Federal Reserve, shows a positive multiplier effect, it can be a sign of money moving between people and a signal to watch for inflation.

M2 money supply represents money and similar funds such as a money-market account. It is an economic indicator used to forecast inflation as it can be used to measure the amount of money circulating.

"Part of the problem will be that there won't be enough goods. Production is down and capacity falls in deflation, so more money will chase fewer goods," he says.

But he surmises, that factory owners will be gun-shy to hire. The owners will have a few people work overtime and will increase prices. "What happens when there's no production and no capacity to produce goods, it creates velocity (The rate at which money is exchanged from one transaction to another) and catches people off guard," he says.

Overall, Szenberg says deflation is not as much of a problem as possible inflation could be. He cites deficit spending, the health care bill and military spending as inflationary, along with the BP oil spill. "That's reducing the amount of oil available, as is the shutdown in drilling," he says.

BALANCING ACT

Right now, Ghadar, the Penn State economist, and Knabe, the financial adviser, believe the U.S. is in a delicate balance.

Ghadar says the U.S. economy is "touch and go," but Europe will have a more difficult time. "They've already stimulated a lot. The worry is that if they stimulate more, the euro will go into freefall," he says.

So who's doing well now? Brazil, according to Ghadar. "They have not borrowed a lot, so they're not in bad shape. They want everyone hired. They want to spend," he says.

Knabe says he errs on the side of deflation simply because the current U.S. unemployment situation of more than 9 percent means little demand for goods and a possible downturn in the economy exist. Although he favored the initial stimulus, he thinks a second stimulus would be too much. In the end, he advocates a laissez-faire approach.

"If the economy is left alone—the government gets out of the way—it can right itself," he says.

Debbie Carlson is a freelance writer who has covered commodity markets for many years. Most recently she was the commodities news editor for the Americas at Dow Jones Newswires, where she also contributed to the Wall Street Journal, Barron's and appeared on Fox Business News. Carlson is a regular contributor to SFO Daily.

Investing in Uncertain Times

The current uncertain economic environment makes it challenging for investors to profit, but financial market advisers say the best way to profit or protect investments is the boring way: portfolio diversification.

A broad, globally diverse portfolio can even out the bumps in investing, with the idea that when one sector or region suffers, another does better. For those who seek a more active plan, some other ideas may be worth trying.

3-LEGGED STOOL

"A three-leg bond strategy holds up best in every economic environment: deflation, inflation, slow growth, higher growth. One of the legs will tend to perform better," says Brian Knabe, financial adviser and certified financial medical planner, Savant Capital Management.

He says high-quality bonds are the best, suggesting both government and corporate debt, and Treasury Inflation-Protected Securities, better known as TIPS. They are inflation-indexed bonds issued by the Treasury Department, with the principal adjusted to the Consumer Price Index.

John Lekas, CEO of money-management firm Leader Capital, also believes high-quality debt will perform best, especially if deflation is a concern. "You can go extreme and buy Treasuries and cash, but there's a point of diminishing returns," he says.

NEW RECORD-LOW YIELD

Indeed, just in July the three-year Treasury note was auctioned at what was at the time a new record-low yield of 1.055 percent.

The problem with deflation is that all asset prices lose value, so the best investment for someone thinking that this might occur is cash, says Shawn Hackett, president of Hackett Global Advisers.

"For a little more sophisticated person, they can short the S&P futures if they want to participate. You can short commodities like copper and crude oil," Hackett suggests.

Concerns about fiat currencies and the global economy in general have sent investors flocking not only to Treasuries but also gold for safe-haven assets. But in the event of deflation, not even gold is immune. Hackett points out in 2008 gold sold off sharply, but he also notes that gold may fall less than everything else.

Dr. Michael Szenberg of Pace University says that gold certainly offers its own unique allures, but storing the physical metal safely is just one issue, which is why he advocates either options or Treasuries.

On the flip side, if inflation becomes a concern, then hard assets become in vogue. "Commodities are the natural hedge, a generous portion in international stocks to reflect the change in currencies," Knabe says.

Hackett says equities generally perform poorly in an inflationary environment because it eats into profit margins. "Some people say go into equities of companies that produce hard assets, but that [strategy] doesn't do as well as commodities themselves," he says.

To get a glimmer of possible inflation, Knabe says to keep an eye on the price of TIPS. "It's a predictor of collective wisdom ... but beyond that, there really are not signs [of inflation], only [those] in retrospect," he says.