

CENTRAL NEW YORK

BUSINESS JOURNAL

Inflation Or Deflation: What Are The Risks?

By Willard C. Lipe III, Patrick M. Dalton, and Gregory S. Mann

Inflationary and deflationary trends have both made headlines over the past year.

Rising prices, notably in food and energy, have caused the Consumer Price Index (CPI) to rise at rates not often seen in recent decades. Simultaneously, home values have been deflating at rates not seen since the Great Depression.

What many don't realize is that the inflation measured by CPI would have been far higher had it not been for the concurrent deflation in housing costs brought about by the collapse of the mortgage-lending industry.

To some extent, inflationary and deflationary trends coexist in a dynamic economy as productivity and technological change offset the impacts of population growth and rising incomes. A problem occurs when either the inflationary or the deflationary trends become dominant in the economy by spiraling out of control.

The recent collapse of global commodity prices, most notably oil, has greatly reduced the risk of an inflationary spiral. However, the deflationary pressures due to the ongoing mortgage-lending crisis raises the risk that the economy will enter a period of spiraling deflation.

Deflation is caused by a contraction of money and credit relative to the volume of goods offered for sale in the economy. This is exactly the situation that exists in the U.S. housing market.

The problem we see is that the contraction in money and credit is spreading to the rest of the general economy by way of a banking industry that is so depleted of capital that it is increasingly unable, or at least unwilling, to provide credit to clients — thus leading to a credit contraction.

Had it not been for the commodity price

bubble of the past year, it would have been evident that the U.S. economy had entered a period of general asset deflation in 2008 with the value of U.S. productive assets (crudely measured by the S&P 500) falling some 20 percent over the past 12 months and rebounding very little as oil prices fell from \$145 a barrel to under \$100.

The two most severe economic periods of deflation in the United States were preceded by excessive and careless lending practices. Consumers became overburdened by debt caused by extensive borrowing.

A negative shock to the financial system such as rising unemployment and credit contractions makes servicing the debt unmanageable. This can lead to a decline in consumer confidence and a reduction in consumer spending, which accounts for 70 percent of U.S. gross domestic product.

Prices fall, but the inability or reluctance of consumers to spend lowers prices further. As prices fall, corporate profits eventually decline. Since businesses become unprofitable, production is cut and unemployment rises, further eroding consumer confidence.

This leads to a downward price spiral. Borrowers are forced to sell other assets, reducing their value, in order to service existing debt.

In normal economic times, the Federal Reserve has measures at its disposal to stem deflation, such as lowering interest rates. By purchasing government securities, the supply is decreased and prices go up. The effect is lower interest rates and an increase in the supply of money.

Another means of curbing deflation is by expanding fiscal policy and increasing government spending, resulting in an increased budget deficit. Sometimes, the government is forced to take more extreme measures such as we have seen recently.

The legislation for a \$700 billion infu-

sion of capital is aimed at not only proving liquidity, but also restoring confidence in the financial system. Whether the bailout plan is successful or not, the deflationary cycle will eventually begin to reverse when banks become comfortable with the value of the collateral they hold and begin making loans again.

So how should the individual investor approach a deflationary cycle? Most important, maintain a strong cash position. The asset liquidations that are occurring due to over-leveraged individuals and institutions trying to cover their losses will create buying opportunities.

As evidence, Warren Buffet recently invested more than \$10 billion combined in Constellation Energy, Goldman Sachs, and General Electric.

Remember, it is a deflationary cycle, and like all cycles it will eventually end, perhaps abruptly. Be cautious about long-term investments that rely on the deflationary cycle to provide attractive returns. It is a cycle, so it is a temporary market condition.

Also, be skeptical about broadly buying into market rallies, the stock market is volatile as it seeks a bottom and many rallies only last a few days, followed by a wave of selling.

And finally, keep your expectations for investment returns modest. If the CPI declines next year, which seems distinctly probable, any positive rate of return will be amplified by the increased purchasing value of the underlying investment capital. □

Willard C. Lipe III and Patrick M. Dalton are the co-founders of Lipe & Dalton, investment counselors. Gregory S. Mann recently joined the firm on a consulting basis. Lipe & Dalton is located at 109 S. Warren St., Suite 1107, Syracuse, NY 13202; telephone (315) 428-8585.