

Economic Commentary

Economic Theme: Runaway Deflation?



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As incredulous as it may seem, the odds of deflation continuing and intensifying are increasing, in our opinion. Surprisingly to some, deflation, defined as a drop in general price levels, has been evident globally for several months now. In the US, for example, headline consumer prices, which include food and energy prices, have been declining at an accelerating year-over-year rate for nine consecutive months commencing last December. The CPI shrank an average 1.6% in July and August compared to a negligible 0.2% drop in the first quarter. From a global perspective, eurozone prices have declined for four straight months; Japan's deflation is at a record low; and even China experienced a drop of 1.2% in August.

So, will this downward price spiral continue? Our analysis suggests that while the term "runaway deflation" might be a slight exaggeration, deflation is likely to persist for several more quarters. Because forecasting headline inflation is comparatively more difficult than projecting core CPI which excludes food and energy, we prefer to focus on the latter. Moreover, definitive trends in core inflation can overshadow food and energy influences. We nonetheless make broad assumptions for food and energy price trends once we have established the core forecast.

We have approached the core CPI forecast from two model perspectives: 1) as a function of the residual between personal income growth and real GDP growth; and 2) as a function of leading indicators (Economic Cycle Research Institute) two years earlier. The latter model suggests core CPI could register increases of 0.5% to 1.0% in the

short-run versus an average gain of 1.7% year-to-date as of August. If, as we suspect, core disinflation (the slowing down of price increases) continues as companies compete for revenues, headline inflation should remain subdued. (As indicated in last month's comment, CPI deflation could be masked somewhat in 4Q09 by energy prices which dropped precipitously a year ago.)

On the surface, one might think that deflation is a good thing as consumers can purchase more goods and services for the same amount of money. This viewpoint ignores one of the causes of deflation: serious economic weakness. With faltering jobs, wage rates, wealth and credit, consumers are less able to spend as is now apparent. The other dire consequence of deflation is a potential shortfall in corporate revenue and earnings growth. S&P 500 sales are already accelerating to the downside with declines of 14% in 4Q08, 17% in 1Q09 and nearly 20% in 2Q09. The hit to earnings has been forestalled by cost cutting and inventory liquidation. Top line disappointments might persist, however, as households and businesses save and hoard money rather than spend it. The risk to earnings is apparent, particularly as revenue recovery typically lags a general economic upturn.

Return Expectations

Our search for excess return or alpha starts with an assessment of the market's conventional wisdom as it relates to various economic scenarios/regimes. This assessment is based on historical asset class returns over a 3-and 6-month time horizon. We then interject our economic/regime assumptions to anticipate upside and downside asset class surprises based on actual developments.

Fixed-income returns for 3- and 6-month periods ended September 30 imply subdued inflation and increasing uncertainty. Equity returns, on the other hand, suggest an economic environment of normal growth (V-shaped recovery). One of these asset classes is obviously off sides. In addition, equity volatility (VIX) is pointing to increasing uncertainty, and real return bonds and commodities are signaling moderate inflation.

Our outlook is squarely on the side of weak economic growth, disinflation/deflation and higher uncertainty. These assumptions cause us to continue to expect better returns from fixed-income markets than equities. In view of persistent core price disinflation, we continue to anticipate a 2.2% yield on 10-year Treasury notes. We believe equity performance has outdistanced fundamentals and has perhaps been spurred by portfolio managers playing catch-up, short covering, program trading and liquidity. Our 950 fair value assessment for the S&P 500 Index remains intact. Interestingly, since our last commentary dated 8/31 through last week's close (10/2), the 10-year Treasury note has outperformed the S&P 500 Index with an annualized total return of 22% versus 7%.

Asset Allocation Recommendation

Our recommendation remains overweight fixed-income and underweight equities. We also have an international tilt versus domestic. In the alternative asset category, we are overweight equity volatility (VIX) and have no exposure to commodities or commercial real estate.

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