

## DEFLATION AND INFLATION ECONOMIC THREATS

Peter Mallouk, J.D., MBA, CFP  
Chief Investment Officer  
[www.thinkingbeyond.com](http://www.thinkingbeyond.com)

You cannot open a financial magazine or newspaper today without encountering an opinion as to whether we are on the brink of a deflationary or inflationary crisis. In fact, we have received more questions about this issue than any other in recent months. The questions fall into several categories:

1. What is deflation and inflation? (In general, most people understand the latter.)
2. How does it come about?
3. What are the consequences to the economy, and more specifically, my portfolio?
4. How should I be invested to protect against it?

*“You can look no further than your home for an example of deflation.”*

First, let's start with deflation. Deflation means the economy “deflates” due to falling prices. Deflation mainly results from (1) lack of demand or (2) aggressive competition coupled with technological innovation. Deflation is taking place right now in the form of lack of demand, as it does temporarily in virtually all recessions. When demand for goods and services goes down, the sellers of the goods and services lower their prices to entice consumers.

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You can look no further than your home for an example of deflation. The average American house is down in value approximately 20%, and almost everything you want to put in it is down in price as well (furniture, clothes, etc.). Many other prices have declined, including cars, vacation packages, commodity prices such as oil and food, and meals at the local fast food outlet (dollar value menu anyone?). While all of this is due to reduced demand for these goods and services, deflation can become much worse if people assume prices will continue to fall. Why would a consumer buy a house today for \$400,000 if that house may be selling for \$350,000 a year later?

This sort of demand-driven deflation is not to be confused with the “healthy” kind, which comes about from technological advances coupled with a capitalist, competitive marketplace. For example, the laptop on which I am typing this letter is twice as fast as my old one, and costs almost half the price. Flat screen TVs have better pictures today than last year, but are less expensive. New cell phones cost less

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than last year’s model, but have more features. This sort of productivity-driven deflation really needs a different word to describe it because it occurs in healthy and sick economies, is a natural part of economic progress in a technologically advanced, capitalist society, and is generally good. Unfortunately, when we talk about deflation in the economy today, we are talking about the “bad kind,” the kind that drives down prices of everything because demand from consumers has fallen.

While deflation is customary in recessions, it typically subsides and gives way to reflation, which is the recovery of prices once the economy pulls itself out of a recession and moves back towards economic expansion. When deflation sticks around, it starts to have horrible effects on the economy, the country continues a general decline, we rename our recession a depression and hunker down for the duration.

The last time we saw significant deflation in America was the Great Depression. Most economists credit deflation for paving the way into that economic disaster. The last modern economy to feel the economic consequences of prolonged deflation is Japan, which experienced deflation in the 1990s. Their economy came to a standstill and took more than a decade to recover.

Inflation means the cost of goods and services goes up. It generally occurs all the time, except for a part of the recessionary cycle. It is common for the price of goods and services to rise a few percent per year. That is the reason we account for inflation in all of our planning.

When inflation becomes “hyperinflation” (high inflation), it means prices are going up far more than normal. For example, it is historically normal for prices to increase approximately 1% to 3.5% per year, but it is not normal for them rise 10% to 15% per year.

Hyperinflation usually happens when there is a larger amount of money chasing the same amount of goods. For example, let’s say your neighbor’s daughter is selling lemonade and all the kids in the neighborhood have a dollar from their allowance. The lemonade stand may make some sales at a dollar. Now, let’s assume the children’s parents decide to “stimulate” the neighborhood economy and give their children an increase to a two dollar allowance. Under this scenario, there would be twice as much money chasing the same girl’s lemonade stand and the price of lemonade will go up.

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When high inflation sticks around, it also has horrible effects on the economy because it erodes the purchasing power of a dollar. A dollar, in and of itself, is not worth anything other than what it can buy. For example, assume one dollar can buy a soda at a fast food restaurant. If we experience 15% inflation, the restaurant would raise the price 15% to \$1.15. The same dollar would no longer buy the soda. Even though you still have the same dollar, it has lost purchasing power and, at the end of the day, a dollar

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is only good for its purchasing power. The last time America went through a hyperinflation cycle was from the mid-1970s to the early 1980s, when inflation ranged from 10% to nearly 15%.

So, which is worse – inflation or deflation? Deflation, by far, is a more dangerous animal. While high inflation erodes purchasing power and forces an economy to struggle for a time, deflation can cause a recession to descend into a prolonged depression. As prices continue to go down, consumers put off purchases, which forces companies to cut costs (more lay offs). With less employed consumers, there is less demand, prices drop further, and the downward spiral can continue. This is one of the main reasons why we saw both the Republican and Democratic Presidents and Congresses take dramatic action to jump start the economy at the end of 2008 and beginning of 2009.

Another reason why deflation can be much worse than inflation is there are very few tools to fight it. When prices rise rapidly, causing high inflation, the Fed can increase interest rates. High rates make it more expensive for Americans to obtain loans to buy homes, cars and so on. With less people in the market purchasing new goods and services, demand softens and prices tend to stabilize. If inflation keeps going up, the Fed can keep raising rates, essentially driving up the cost of money until it obtains the desired effect.

With deflation, there are limits to what the government can do to combat it. In late 2008 and early 2009, we saw housing and other asset prices tumble. In part to stop deflation, the Fed lowered interest rates. By making it cost less for Americans to borrow, it is easier for consumers to afford larger mortgages. Thus, lower rates can drive more buyers into the market, and keep people in their homes who could not afford their mortgages at higher interest rates. If deflation persists, the Fed can fight it by further lowering interest rates.

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However, there is a limit to how low rates can go, since there is nowhere to go past zero, at which point the Fed is “out of bullets.” The Fed lowered rates close to zero already, as Japan had done in the 1990s. It is important to note that the U.S. government has taken more action to fight deflation in the last 9 months than Japan took through all of the 1990s.

Economists, God love them, are totally conflicted about our current situation. A minority of economists are concerned that we are moving into a period of continued deflation that will lead to a prolonged recession or depression. They predict falling prices across the board, led lower by decreasing housing, oil and other commodity prices. They believe deflation is the major economic threat, citing the fact that the consumer is terrified and, therefore, will

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continue to avoid major (and even minor) purchases. This lack of demand for goods will drive down prices. As of 5/31/09, the consumer price index has fallen 1.3%, its largest year-over-year decline since 4/30/1950.

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A larger number of economists are concerned about inflation. They predict the increased amount of money in our system – all pumped into the economy by the stimulus packages and other governmental actions – will eventually create a situation where all the money chasing the same goods dramatically drives up prices. Of course, there is yet another group of economists who think we will come out of all this without serious deflation or inflation. At the end of the day though, no one really knows how this will play out (contrary to the strong opinions of commentators, economists, and many Americans who are convinced we are facing one or the other).

The Fed’s top priority is to stabilize the economy, avoid deflation, and get back to normal inflation. The United States favors inflation since we are largely a debtor nation. We owe \$10 trillion dollars to people and countries that have loaned us money. Assume, for a second, that we stop borrowing more money (try real hard!). If we have inflation, the price of everything goes up, including the income individuals earn. That means the government collects more taxes. If inflation is at 4% and the cost of borrowing is at 3%, the extra 1% of inflation makes it easier for the U.S. to pay off the debt and hurts those who loaned the money, which are largely U.S. citizens and foreign governments. That is why Alan Greenspan called inflation the “hidden tax.” This concept is no different than an individual who has a \$100,000 fixed mortgage at 5% for thirty years. As time goes by, the monthly payment gets a lot easier because the individual makes more money (inflation) and the cost of the debt remains the same. Paying \$1,000 a month on a mortgage now may sting a little, but might be the equivalent of a night on the town in 25 years. Inflation helps the debtor and hurts the lender.

In the event we are, in fact, on the verge of a severe deflationary cycle, prices will go down. In this sort of environment, high quality bonds will perform very well. It looks really good to collect 5% to 7% on bonds while prices are declining. Under this scenario, you could take a million dollars, turn it into \$1,060,000 a year later, and in the meantime have the added benefit of declining prices on nearly everything else.

In the event we are, in fact, on the brink of hyperinflation, prices will go up significantly. Under this scenario, commodities, real estate and stocks will likely perform best. As demand increases, the cost of commodities like oil and agriculture will rise. Real estate owners will see their costs of maintenance and other expenses climb. They will charge higher rent, and that will drive up the

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value of the property. Companies will experience rising production costs that they will pass to the consumer by increasing prices, and which will ultimately be reflected in a higher stock price.

The best course of action for a portfolio is to avoid betting the bank on one scenario and make sure the investor is never at the mercy of deflation or inflation. By owning the various asset classes, an investor can always access the part of the portfolio that is performing best and allow the other asset classes time to recover as the deflationary or inflationary pressures subside, which they always do. Investors that hold 100% bonds or cash often feel they are being “safe,” but they could see their portfolios lose 20% to 50% of their purchasing power in a high inflation environment. The erosion of purchasing power is the main reason why it is important to hold investments that have a high probability of beating inflation over the long run. Likewise, investors that hold 100% stocks, real estate and commodities – in an attempt to offset inflation – can potentially suffer significant losses in a prolonged deflationary cycle.

As always, the investor’s unique, personal circumstances come into play when designing the best portfolio, with a special focus on the investor’s time horizon, tolerance for short-term volatility, and long-term goals.

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