September 2009: Inflation or Deflation?

People most often equate inflation with a general increase in the level of consumer prices. The actual definition of inflation is *an increase in the quantity of money and credit*. When the quantity of money increases, prices rise as more and more funds chase assets and consumables – so rising prices are a *symptom* of inflation. The symptom can manifest itself in different ways such as through higher prices of commodities, houses and real estate, stocks, insurance contracts, education, or in wages and consumer prices. Furthermore, different areas of the economy can become inflated at different points in time (think tech, housing, etc.)

The reason the "inflation or deflation" debate is raging currently is that we are in a situation where the government is increasing its fiscal deficit to inject cash and credit into the system *to offset* the withdrawal of credit by the private sector.

This environment is challenging for investors as the whole point of investing is to increase your *real* wealth through time. That means holding investments which should increase in value at a greater rate than money and credit is expanding. The difficult part is to know into which assets the expanding money supply will flow. As an example, since December 2008, in the wake of what most would argue was a global deflationary shock, oil traded from $32 to $70, but natural gas traded from $6 to $3. During this same time period different economic forces were at work – crude oil is priced globally, and natural gas is priced by supply/demand mostly in the U.S.

The debate of inflation vs. deflation will continue because there are some credible arguments for both sides. However, it is our view that inflationary forces will ultimately prevail. At this point, governments have embarked on hugely expansionary monetary and fiscal policies, which is the very definition of inflation. The private sector has tightened credit, so there is a tug of war, but this will likely change as balance sheets are strengthened. We live in an economic system where some prices will rise and some will decline as we observed in the contrasting price action in oil and natural gas. This process is continuous and particularly evident in asset classes where there are either shortages (which will attract capital investment) or where there are massive excess capacities (which constrain new capital investments). Zero interest rates also cause risk adverse investors to take more risk than they otherwise would – thereby likely inflating certain riskier asset classes as they seek returns.

The deflationists may be right about the fact that the rally in the S&P500 off the March bottom has gone too far too fast because the economy is still structurally weak. But on the other hand,

you could also argue that the recent increase in asset prices makes perfect sense in light of global monetary stimulus and continuous liquidity injections. The money has to go somewhere.

What this means for investors is that *because* there are powerful deflationary and inflationary forces at work, volatility should be expected. To protect clients from anticipated inflation, we want to avoid investment in industries that have too much capacity (i.e., auto manufacturing, hotel and leisure, financial services, and real estate), and overweight industries where there is likely to be constrained capacity in the future (i.e., energy production, electricity generation and distribtution, agricultural production and healthcare). And in the context of an inflationary environment, we believe that over the next ten years stocks will perform better than cash and bonds and recommend for one's long-term investments maintaining exposure to equities despite near-term challenges.

Past performance may not be indicative of future results. Different types of investments involve varying degrees of risk, and there can be no assurance that any specific investment will be suitable for an existing or prospective client's investment portfolio. Therefore, no existing or prospective client should assume that future performance of any specific investment or investment strategy (including the investments or investment strategies recommended herein) will be profitable or equal any historical performance levels. Certain portions of our newsletter may contain discussions of recommendations as of a specific prior date. Due to various factors, including changing market conditions, such discussions may no longer be reflective of current positions or recommendations. Information included herein should not be construed as the receipt of, or a substitute for, personalized individual advice. A copy of our current written disclosure statement discussing our business operations, services, and fees is available upon written request.