

# Investment Update



August 2010

## Blue Light Special

Everyone likes a good deal, so it can be hard to understand why lower prices are not always a good thing. In my youth, when a teen could actually secure employment, I worked in the shoe department of a discount retail store. The store developed a selling technique whereby a store worker — frequently yours truly — would wheel out a mobile, police-style flashing light and announce, “attention Kmart shoppers, there is a blue light special in the shoe department.” In the early days, this technique apparently brought customers running. However, by the time I started there, the tactic had become less successful. Why? For something to be truly “special,” it shouldn’t happen often and should typically be a surprise. Frequency and predictability remove urgency and, thus, reduce demand. If you know that the price of something will decline soon, why hurry to buy it now?

While not typically thought of in this way, consumers tend to like a decline in the relative price of a good or service. For example, the cost of a steak at restaurant A is lower than the price at restaurant B, or the price of steak today is low compared to the usual price and low also compared to what it will be tomorrow.

If prices decline while incomes remain the same, an improved standard of living would result. Unfortunately, broad declines in general price levels — the definition of deflation — are much less favorable because they typically are caused by a collapse of aggregate demand and indicate poor conditions such as a recession, rising unemployment and financial stress. As companies lower prices to generate sales, they also cut benefits or even wages to maintain profitability, creating a negative feedback spiral

that exerts continuous downward pressure on prices and incomes. As consumers' incomes fall, they spend less and as prices drop, they wait longer to buy. This negative trend can be seen in the chart below, which shows Japan's CPI from 1970 to the present. This cycle can be

goods and level of income decline, our debt often is fixed. Consequently, the real cost of borrowing rises. Debt repayment with dollars that are in short supply often results in great strain on borrowers. At a minimum, this stress results

## Deflation Can Be Hard To Escape - Ask Japan

Year-to-Year Change in Japanese Core Consumer Price Index Excluding Food



As of 5/31/10. Sources: Haver Analytics and Ned Davis Research

hard to break, so it is understandable why Fed Chairman Ben Bernanke has dedicated so much time to the study and discussion of the issue.

Another downside of deflation is that, even though the price of

in reduced spending by those affected. However, if this issue becomes widespread, economic and financial stability can be jeopardized.

## Dealing with Deflation

In his November 2002 speech titled, *"Deflation: Making Sure 'It' Doesn't Happen Here,"* then Fed Governor Bernanke outlined the definition, cause, prevention and cures of deflation. At the outset, he said that he believed the chances of significant deflation in the United States in the foreseeable future were extremely small. He cited two principal reasons: The first was the resilience and stability of the U.S. economy and its ability to absorb shocks of all kinds. This factor was displayed during the recovery of the financial crisis of 2008-2009. The second factor he cited as "the strength of our financial system: Despite the adverse shocks of the past year (2002), our banking system remains healthy and well-regulated." This second protective factor, however, has proven less helpful to say the least.

Many of the ideas that Bernanke raised in discussing deflation prevention and cures in his speech were the same policies that were introduced as the financial crisis deepened. These included trying to preserve a buffer zone for the

inflation rate (that is, during normal times, not trying to push inflation down to zero); acting preemptively and aggressively to cut rates if the fundamentals of the economy suddenly deteriorated; communicating that rates likely will remain exceptionally low for an extended period; and adopting other measures beyond interest rate cuts if rates had been cut to zero, such as targeting yields on longer maturity Treasury debt, making asset purchases in the markets for agency debt, and offering loans for eligible collateral.

While not our forecast, if the U.S. economy substantially weakens, the Fed likely would employ a number of these policies to attempt to revive growth. The most potent of these tools is quantitative easing, which includes the purchase of longer-dated monetary debt. While the recent Fed minutes indicate that it does not intend to implement such measures, we are confident it would should the need arise.

## Positioning Portfolios in the Current Environment

Market expectations have changed significantly since the July 2009 *Update* in which we wrote that, while many investors were understandably concerned about future inflation, the challenge would be in correctly estimating the time it could take for inflation to be manifested. We enumerated the factors that led us to believe — as we still do — that inflation was likely some time away. Since July 2009, a significant shift in investors' anticipation of inflation has occurred. At least for now, investors view the probability of deflation, or at least some policy mistake that would create deflation, higher than what we expect. This is evidenced in the record low yields of two-year Treasuries and 10-year Treasuries, which currently have rates below 3%. Not only do we consider a double-dip recession unlikely, but we also believe that the Fed has more potential tools in its kit to avoid a Japan-like scenario. Therefore, we do not place a high

probability on sustained deflation. As such, Treasury securities appear less attractive than normal. We find better value in other areas of the fixed income markets including Treasury Inflation Protected Securities (TIPS) and municipal bonds. We also see opportunity in high-quality dividend paying stocks, but the relative risk of their investments must be considered in each portfolio.

Incidentally, Kmart discontinued the blue light special in 1991, citing changing consumer patterns. Still, I wax a little nostalgic when I see the blue lights flashing on a cruiser in my rearview mirror, and hope that I might get a half-off special on a speeding ticket, just for today.



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