The Stan Clark Financial Team's

PERSPECTIVES

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Asset Allocation

Inflation vs. deflation: Which is more likely?

By Michael Chu, Investment Advisor

We've discussed inflation and deflation, and their likely effects on your investments and financial planning. Now let's look at inflation vs. deflation. Which of them is more likely to happen?

To review, *inflation* is a general increase in prices of goods and *deflation* is a decrease. Stocks can be expected to do well with moderate inflation or moderate deflation. Extreme deflation would probably be negative for stocks. This is because deflation is usually associated with a very weak economy and falling profits. Extreme inflation would likely be bad for stocks initially, but over time corporate earnings should increase with inflation. That means longer-term returns from stocks under high inflation might end up being okay. With stocks, it's not so much the direction of prices that matters but rather the magnitude.

But fixed income, like a bond or GIC, is sensitive to both the direction and magnitude of price changes. Fixed income should do well with deflation, as long as the principal and income are guaranteed. The more prices fall, the better fixed income looks. But fixed income does poorly with inflation. The more prices rise, the worse it is for fixed income, as it loses its ability to buy things.

So, what's the outlook ahead? Is it deflation or inflation?

As shown in the chart, over the past 100 years inflation has averaged 3.2% per year in the U.S. However, there is considerable debate among academics and money managers over whether we are more likely to see deflation or inflation in the years to come.

Many economic experts believe that deflation is more likely than inflation. That's often the reasoning bond investors use to justify buying 10-year bonds that currently yield only around 2%. If you believe we are going to face inflation, locking yourself into a 2% bond yield for 10 years wouldn't be very smart.

Many of these bond bulls point to the theory of "debt-deflation," first described by the American economist Irving Fisher in 1933, and later developed by other economists such as Hyman Minsky.

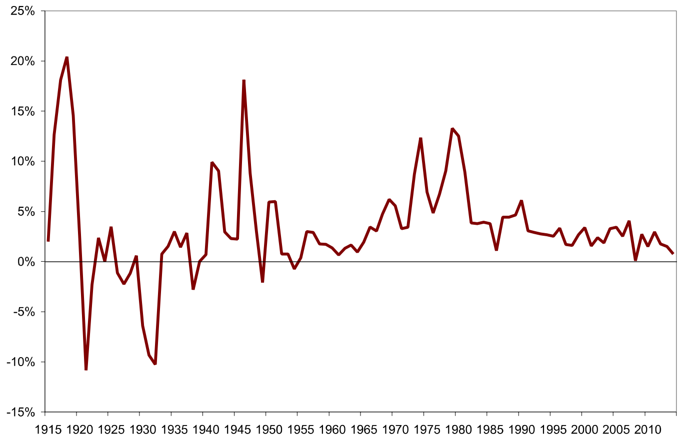
According to the debt-deflation theory, when an economy accumulates too much debt a financial crisis can result. People frantically sell assets to pay off debts. This results in a decline in asset prices, a progressive slowing of the economy and continued decline in prices and incomes. Once the downward decline in prices begins, it can build on itself, leading to losses by banks and other lenders, the destruction of otherwise good businesses and the loss of good jobs.

This was Fisher's explanation of what happened in the first three years of the Great Depression, when he published his theory. From September 1929 to March 1933, consumer prices in the U.S. fell almost 30%.

People who hold this view also point to the example of Japan. Japan experienced deflation after its real estate and stock markets crashed in the 1980s. For the past 20 years, Japan has experienced very slow growth and regular bouts of deflation. Many prominent economists believe that deflation was a big factor in Japan's slow economic growth.

There is no doubt that many individuals and countries have accumulated too much debt, and this is simply not sustainable. One possible outcome is deflation, which happened both during the Great Depression and more recently in Japan. However, there are also arguments that those periods of deflation could have been prevented. There is a determination on the part of many central banks, including the Federal Reserve, to make sure those mistakes are not repeated. More on this next month.

Inflation (last 100 years)



Source: Siegel/CRSP

CIBC Wood Gundy | The Stan Clark Financial Team
Where planning, investing and behavioral finance meet

Phone: (604) 641-4361 Toll free: 1 (800) 661-9442 Fax: (604) 608-5211 Email: StanClarkFinancialTeam@cibc.ca www.stanclark.ca

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