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Investing in a Deflationary Environment

I am not an economist (and don't even play one on TV) so I can't predict with any confidence whether we are headed for deflation or if inflation will rise to uncomfortable levels in the not too distant future. On one hand, "helicopter Ben's"[1] Fed is "printing money,"[2] which is often described as "quantitative easing." Sooner or later, "logic" would indicate that all the additional money will increase the demand and hence the prices of goods and services. Of course, whether sooner or later is the key question in this scenario.

On the other hand[3], there are several factors that indicate that prices will not be heading much higher if at all for at least several years. With unemployment remaining high, there should be little pressure for generally increasing wages. Factory utilization is well below maximum capacity so production can be increased without major investments in new plants and equipment. Except for governments, there is a strong tendency to reduce debt levels rather than to spend additional money consumers may obtain, and doing so does not increase demand for goods and services in general.

One academic economist by training and mutual fund manager whose opinions I think are well thought out[4] thinks we will not see any significant inflation before the second half of this decade. He expects it to be quite severe when it happens. Although I have no idea if his time frame will be close to on target, I believe that we will see little or no inflation and possibly some deflation for the next couple of years.

We have a considerable amount of information about what type of investments are designed to handle an inflationary environment. For example, Treasury Inflation Protected bonds (so called TIPs) will protect purchasing power and provide a modest "real" return. Far less has been written about how to invest

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[1] Before he was Fed chairman he reputedly said that there would never be deflation because as a last resort money could be thrown out of helicopters.
[2] Not literally. The Fed adds money to the system by purchasing various debt securities, which are usually bonds issued by the government or government agencies.
[3] I think it was President Truman who wished that he could get advice from one-armed economists.
[4] I will not say who to avoid embarrassment in case he is wrong or if I have misinterpreted his writing.

in a deflationary environment. The most basic concept is that when prices are dropping, "cash is king." Metaphorically that is putting one's money under the mattress although as a practical matter it would be in a bank account earning little or no interest. The risk to the economy, which is what motivated the helicopter remark, is too many people taking that approach and not spending more than necessary in anticipation of lower future prices. A vicious cycle, such as we saw in the 1930s, is set in motion with increasing unemployment and a drastically slowing economy.

I recently read a list of ideas for investing if we have deflation written by David Rosenberg of Gluskin Sheff. I had never heard of him or the firm, which is a boutique investment manager for the very wealthy. Here is a summary of his seven ideas.

1) High quality corporate bonds issued by companies in non-cyclical industries with strong balance sheets, substantial cash reserves, minimal refinancing needs.
2) Stocks of companies with steady dividend growth, possibly owning preferred shares for higher yields.
3) Whether owning stocks or bonds, avoid highly leveraged companies and look for ones with low debt to equity ratios and substantial liquid assets.
4) Investments in "hard assets" with steady income streams such as oil and gas royalties or income real-estate investment trusts (REITs). [*I am somewhat skeptical about the wisdom of these. If prices fall sharply, the income streams may not be so steady, and in a very poor economy, rental real-estate may become vacant and mortgages may go into default.*]
5) Look for sectors or firms with low fixed costs, high variable costs, some barriers for potential competitors to enter and with relatively inelastic demand such as utilities, health care, and consumer staples.
6) More speculatively, alternative assets and strategies that do not depend on rising stock prices and where volatility can be used to advantage.
7) Precious metals as a hedge against potential effects of increased money supply and currency devaluations.

Most of my investment management methods are suitable for a deflationary environment although they may not produce the potential exceptional profits of some of the investments in the list. The trend following models for investing in market indices (S&P 500, Nasdaq 100) are designed to avoid major drops in stock prices. The models for real-estate funds and gold stock funds also fit some of the points above. Sector fund trading is more speculative and has a greater potential for larger losses. However, my methods can take advantage of

point 5 above although they rely on the movement of sector fund prices rather than the type of fundamental analysis described there.

Taking a broader view, we are still in the secular bear market that began ten years ago and can be expected to last another seven to ten years. See my last interim newsletter for one view on why that it is so and an indication when the bear may be ready to go back into hibernation. In such markets, investing in equities requires much more attention to risk control than during secular bull markets when losses usually can be recovered fairly quickly. The ultimate risk management measure is not to have too much in stocks and equity funds. One good measure of how much is too much is that money that will or may be needed within five years should not be in stocks, particularly if one is going to "buy and hold" (and hope). The risk that sales to raise needed money may be a time when stock prices are depressed is just too great.

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