The dreaded 'd' word

Friday, 27 August, 2010

Fear of deflation haunts investors and stalks the halls of the Federal Reserve in Washington. But how bad are declining prices, and why have they become a problem? And the question is should investors and the US central bank stop worrying and learn to love deflation, at least at moderate levels? For 70 years, deflation was a distant threat as policymakers and economists wrestled with the problem of taming high and persistent inflation rates instead. It started to become an issue in the 1990s when annual price inflation dipped below 3.0% for the first time in three decades, sparking a debate about "*optimal inflation rates*" and how the Fed should define its price stability mandate. Eventually a consensus emerged in favour of targeting a low but positive rate of inflation rather than either zero (absolute price stability) or declining prices (deflation). In the United States, the Fed has in practice defined price stability as an increase in non-food and energy prices somewhere between 1.5% and 2.25% per year. Proponents cite "*nominal rigidities*" in wages and prices, interest rates and debt contracts as the reason to favour a non-zero rate of price rises. Inflation gives policymakers and businesses much needed flexibility to cut real wages, prices, interest rates and the debt burden when it is difficult to reduce them further in cash terms. Small amounts of inflation oil the wheels of the economy so to speak. In contrast, deflation is tarred by association with periods of severe economic distress and widespread unemployment during the 1930s and between 1870 and 1895, as well as the more recent experience of Japan in the lost decades of the 1990s and 2000s.

However, it is far from clear that deflation caused or significantly contributed to the joblessness and malaise in any of these episodes, or whether it was just a symptom. In their influential book from the 1960s "*Monetary History of the United States*", Milton Friedman and Anna Schwarz pinned the blame for the Depression on the Fed's inability to prevent bank failures, not falling prices. Friedman and Schwarz argued the Fed should have done more to provide liquidity to save the banking system, not because it would have stopped prices falling. The idea that prices should trend upwards over time is relatively recent. Persistent inflation dates from the 1940s. Before that, periods of inflation had alternated with falling prices with no discernible long-term trend. Deflation has been the norm, not the exception. In many cases it has been associated with technological innovation, the opening up of new resources, productivity gains and rising living standards. The late 1990s and early 2000s saw an extensive debate that sought to distinguish "*bad*" deflation stemming from credit contraction and debt from "*good*" deflation stemming from productivity gains and technological change.

Nor is it clear the "*nominal rigidities*" identified by Nobel Laureate Paul Krugman and others are so sticky in practice. As inflation has fallen close to zero, once-unthinkable cuts in wage and salary rates have become more common as an alternative to job losses. It is also possible to push interest rates negative through the use of account maintenance fees and transaction charges. Many customers in the United States, the United Kingdom and elsewhere are already getting negative rates on current accounts once fees are taken into consideration. There is nothing to stop policymakers from imposing a fee on excess reserves or even required reserves held with the Federal Reserve, or commercial banks from imposing similar fees on their customers. It might not be customary, but it is not impossible. It is no more radical than some of the unconventional monetary policies that have been tried since 2007. Even on the vexed issue of debt contracts, there is in principle no reason why future contracts could not be indexed to take account of both price increases and price falls. Even on existing contracts, there is no reason in principle why moderate rates of inflation (which punish savers) should be preferable to moderate rates of deflation (which punish borrowers). It is simply a question of redistribution. The key word here is "*moderate*". In the same way inflation may not be a problem provided it is limited to a few percentage points per year, deflation is also unlikely to present major difficulties so long as it remains moderate. We are not saying deflation is good, but rather we are challenging the mindset that has taken hold among policymakers that inflation of 0-3% is somehow a positive thing, while price declines of 0-3% per year represent a disaster.

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International Bonds/Equities:

No doubt, if a new recession takes hold then there will be a further significant drop in equity prices. But, even without a recession, there will be enough uncertainty about the outlook to keep investors on edge and it's not clear how long that situation may persist. The continuing decline in the US and global leading economic indicators, suggests that the data will continue to disappoint for at least in the near-term. On this basis, the prudent strategy is to have no more than benchmark equity and corporate bond weightings until a clearer picture emerges and leading indicators bottom. That said, investors who are interested in absolute rather than relative returns should hang on to high-quality corporate bonds. These securities have the potential to rally further if Treasury yields head lower. As for Treasuries, yields have fallen to extremely low levels and it is tempting to aggressively short them. Nonetheless, the Fed's decision to reinvest maturing MBS and Agency bonds in the Treasury market suggests that policymakers' tolerance for growth disappointments is low. Additional fiscal stimulus appears to be a non-starter in Washington, leaving the ball in the Fed's court. ***We believe that it may only take another couple of months of weak growth figures to spark the Fed into expanding its balance sheet again. This means we cannot rule out another downleg in bond yields, even if a double-dip recession is avoided.*** Continued below-trend growth is all that is required to motivate the Fed, because it would imply a rise in the unemployment rate. Risk assets will probably rally if the US central bank pumps more liquidity into the system, but the stock and corporate bond markets may riot before the Fed acts. ***Thus, the risk/reward balance has become too unfavourable to maintain a pro-growth investment stance in our opinion.*** In overall terms going forward, though, we think further quantitative easing will do little to help the American consumer and tackle unemployment, with the only real solution more tax concessions for consumers/businesses. Unless we get this, then it is hard to see much improvement on the consumer spending/unemployment front anytime soon or bond yields rising dramatically higher.

Fears of a US economic slowdown may soon drag 10-year US and German government bond yields down towards a record low 2.0%, but higher-yielding UK Gilts may well out-perform them both in 2011. In the shorter-term, US Treasuries will charm investors as their yields tumble the most, with some analysts saying T-notes and German Bunds may reach yield parity as soon as October. But further ahead, ***there is a feeling that Gilts will stand to benefit because investors will want to shun expensive bonds and chase top-rated paper offering better returns from higher yields. There is in our view scope for switches into Gilts, albeit currency moves may give yield-chasers less incentive.*** Nearer term, US Treasury yields have more potential to fall than Bunds, although we think we will need to see some further significant deterioration in the American economic numbers to get yields falling much more from here. However, it would be foolish to rule out parity between 10-year Treasuries and 10-year Bunds over the next few weeks, and a level of 2.00% is not completely off the wall given fears of something sinister happening to US economic growth and even ongoing worries about renewed debt crisis contagion within Euroland. Grimmer economic data from the US and UK economies and the perception that the Federal Reserve and Bank of England will maintain a more accommodative monetary policy stance than the European Central Bank mean that Treasuries and Gilts both have the potential to out-perform Bunds in the near-term. But Germany, the Eurozone's biggest economy, which last week recorded surprisingly strong second-quarter economic growth of 2.2%, and the more fragile Euroland economy as a whole could see growth snuffed out by US weakness. ***The US slowdown is fuelling expectations at the moment that already record-low Bund yields will break a new floor later this year, opening the prospect of them out-performing Treasuries in early 2011 as the US economy, US T-note yields and even Bund yields all start to pick up.*** For the next few months, though, outperformance by Treasuries is on the cards because of the lag in American economic events having a knock-on effect in Europe.

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Currencies/Commodities/Interest Rates

At least seven of the 17 top Federal Reserve officials at the US central bank's August policy meeting had reservations about the decision to buy more Treasuries, the Wall Street Journal reported this week. In a significant policy shift, the Fed announced at its August 10 policy meeting that it would begin using the proceeds from maturing mortgage securities in its portfolio to buy Treasury notes, an effort to prevent monetary conditions from slowly tightening over time. The formal vote at the meeting, 9 to 1 in favour, disguised the extent of the disagreement, the Journal said, citing people familiar with the discussion. ***While the meetings are attended by all 12 regional Fed presidents and five Washington-based governors, only five Fed presidents have a vote at any one time.*** Governor Kevin Warsh worried a decision to reinvest mortgage proceeds into Treasuries would confuse investors and lead many to believe the Fed was paving the way to resume major purchases before it had decided to do so, the newspaper said. Richard Fisher, president of the Dallas Fed, and others expressed concern that US central bank moves might be ineffective, while Philadelphia Fed President Charles Plosser judged the action as premature, the Journal said. ***The extended debate about how best to counter the slowing US economy was eventually settled by Federal Reserve Chairman Ben Bernanke, who pushed successfully to proceed with the move.***

Expectations about income, asset prices, interest rates and risk are central to pricing of all real and financial assets, as well as the spending decisions made by households and firms. Central bankers, policymakers and the financial services industry have spent the past two years trying to rebuild the essentials of the pre-2007 credit and commercial system —- minus the more egregious components. Get credit growing. Restart securitisation (minus the liar loans). Incentivise new borrowing and investment (minus reckless projects). However, that system rested on a set of beliefs about risk and returns that has been comprehensively shattered after it was proved false by the worst financial trauma in three generations. It cannot easily be recreated until the passage of time encourages a gradual forgetting. ***For now, caution about the outlook dominates cheap money and liquidity, rendering monetary policy temporarily impotent.*** By cutting interest rates to zero and supplying unlimited liquidity to the banking system and other parts of the financial markets, central banks have limited explicit defaults and socialised the maturity risk in banks' loan books. Unconventional policies have averted Armageddon in the banking system and a worldwide depression. But ***monetary policy cannot do more to restart growth. It cannot stimulate credit to the real economy.***

Exchange Rates 2010/2011

	Current	End Sept (f)	End Dec (f)	End Mar (f)	End June (f)
€/GBP	0.8200	0.8150	0.8000	0.7800	0.7500
€/$	1.27	1.24	1.18	1.16	1.15
€/Yen	108	106	103	100	100
$/Yen	85	85	87	86	87
GBP/$	1.55	1.52	1.48	1.49	1.53

Official Interest Rates 2010/2011

	Current	End Sept (f)	End Dec (f)	End Mar (f)	End June (f)
US	0.25	0.25	0.25	0.25	0.50
Eurozone	1.00	1.00	1.00	1.00	1.00
Japan	0.10	0.10	0.10	0.10	0.10
UK	0.50	0.50	0.50	0.75	1.00
Canada	0.75	1.00	1.00	1.25	1.50
Sweden	0.50	0.75	1.00	1.25	1.50
Norway	2.00	2.00	2.25	2.50	2.75
Switzerland	0.25	0.25	0.25	0.50	0.75
Australia	4.50	4.50	4.75	5.00	5.00
New Zealand	3.00	3.25	3.50	3.75	4.00
China	5.31	5.31	5.58	5.85	6.12

2010/2011 Native Global Bond Yield Forecasts %

	Current	End Sept (f)	End Dec (f)	End Mar (f)	End June (f)
US					
2 Year Treasury	0.54	0.65	1.05	1.55	2.05
5 Year Treasury	1.40	1.55	1.85	2.25	2.65
10 Year Treasury	2.52	2.70	2.95	3.25	3.55
30 Year Treasury	3.55	3.75	3.95	4.20	4.50
Germany					
2 Year Bund	0.62	0.80	1.10	1.45	1.80
5 Year Bund	1.23	1.45	1.70	2.00	2.30
10 Year Bund	2.14	2.40	2.60	2.85	3.10
30 Year Bund	2.65	3.05	3.25	3.50	3.75
UK					
2 Year Gilt	0.62	0.85	1.20	1.60	2.00
5 Year Gilt	1.62	1.90	2.20	2.55	2.90
10 Year Gilt	2.87	3.15	3.40	3.70	4.00
30 Year Gilt	3.83	4.20	4.45	4.75	5.05

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Key International Economic Indicators/ Events of the Week

US: FOMC Minutes (August 10) (Tuesday 31st, 19.00 BST)

Given that at least seven of the 17 top Federal Reserve officials at the US central bank's August policy meeting had reservations about the decision to buy more Treasuries, according to the Wall Street Journal, the minutes of the August 10 policy meeting should make more interesting reading than usual. Kansas City Fed President Thomas Hoenig has been very much out on his own at recent meetings, taking a much less 'dovish' stance than his colleagues.

Any evidence that Hoenig may be getting support from other policymakers as regards the Fed's ultra-easy monetary stance, could put upward pressure on short-dated Treasury yields.

US: ISM Manufacturing Index (August) (Wednesday 1st, 15.00 BST)

2000=100	Headline Index	Prices Paid
2009 August	52.8	65.0
2010 June	56.2	57.0
2010 July	55.5	57.5
2010 August (f)	**52.5**	**56.0**

The further fall in the ISM manufacturing index in July was smaller than feared and is consistent with more modest easing in economic activity rather than newfound economic malaise. By falling from 56.2 in June to 55.5, the headline index is now 5 points below April's peak of 60.4. The slowdown that began in the second quarter has therefore continued into the third. The key point, though, is that the index is falling from a high level. Even after July's dip, it is still consistent with annualised GDP growth of about 4.0%. Moreover, although the index may yet fall further, as the boost to growth from inventory rebuilding and the rebound in world trade continues to fade, it is hard to see it dropping to the level of 45 that would signal another recession.

However, the bottom line is that the ISM index is likely to fall further in August, which will push Treasury yields even lower in the short-term.

Eurozone: ECB Policy Decision (September) (Thursday 2nd, 12.45 BST)

The ECB is likely to maintain a very dovish stance at its forthcoming meeting. Admittedly, recent positive data might have led the Bank to revise up its growth forecast for 2010. But the slowdown in global demand is a very worrying sign for the future. As inflationary pressures are totally absent, we see no reason to change our view that official interest rates will be on hold until well into next year at least. Meanwhile, with '*peripheral*' bond yields still rising and many banks in these economies heavily reliant on ECB funds, unconventional policy support is likely to be maintained for quite some time too.

The underlying tone of this latest meeting is likely to be 'dovish', which should however boost core Euroland Bunds over 'peripherals'.

US: Non-Farm Payrolls (August) (Friday 3rd, 13.30 BST)

S.A.	Net Payrolls Change ('000)	Unemployment Rate %	Hourly Earnings: Monthly Change %	Hourly Earnings: Annual Change %
2009 August	-212	9.7	0.4	2.5
2010 June	-221	9.5	0	1.8
2010 July	-131	9.5	0.2	1.8
2010 August (f)	**-98**	**9.5**	**0.1**	**1.5**

The US labour market remains very weak, with another very modest gain in private payrolls in July being swamped, not just by more Census layoffs, but massive job cuts by state and local governments as well. In total, payrolls dropped by 131,000 in July, a little better than the 221,000 fall in June, but only because June's drop was revised up from the initial estimate of 125,000.

There isn't likely to be much joy from the August payrolls data either, with another headline fall of around 100,000 keeping downward pressure on bond yields.

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Main Debt Auctions/Announcements in the Coming Week:

Monday 30th	Italian Treasury sells 2.00%, 2013 and 3.75%, 2021 BTPs and floating-rate 2015 CCTs.
	French Treasury sells €9bn of BTFs.
	Poland sells up to €800m zlotys of 52-week T-bills.
	Hungary sells 6-week T-bills.
	Slovakia sells 4.00%, 2020 SLOVGB214 government bond.
	Lithuania sells 2013 government bonds.
	Federal Reserve purchases TIPS.
	US Treasury announces details of forthcoming 10-year TIPS sale.
	US Treasury sells 3-month and 6-month T-bills.
Tuesday 31st	Norway sells T-bills.
	Belgium sells T-bills.
	Switzerland sells 3-month T-bills.
	Hungary sells 2-week and 3-month T-bills.
	Canada sells C$7.4bn of 98-day T-bills, C$2.8bn of 182-day T-bills and C$2.8bn of 364-day T-bills.
	US Treasury sells 4-week T-bills.
Wednesday 1st	Japan's Ministry of Finance sells 3-month T-bills.
	Japan's Ministry of Finance sells 10-year JGBs.
	Sweden's Debt Office sells 2.5bn krona of 4.50%, 2015 SGBs.
	Czech Republic sells 7bn crowns of 3.40%, September 2015 bonds.
	Poland sells zero coupon bonds.
	Russia sells 35bn roubles of OFZ bonds; series #25073.
	Canada sells 30-year bonds.
	Federal Reserve purchases notes/bonds.
Thursday 2nd	French Treasury sells OATs.
	Spanish Treasury sells 3.00%, April 2015 Bonos.
	UK's DMO sells £3,750m of 5.00%, 2014 Gilts.
	Hungary sells 12-month T-bills.
	Czech Republic sells 7bn crowns of 91-day T-bills.
	Romania sells government bonds.
	US Treasury announces details of forthcoming 3-year, 10-year and 30-year bond sales.
	US Treasury sells 10-year TIPS.
Friday 3rd	UK sells T-bills.

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