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STERLING'S WORLD REPORT

## Is the U.S. Headed for Japanese-Style Deflation?

During recent visits with clients, one of the most frequently asked questions has been whether the U.S. will end up with Japanese-style deflation. Following the U.S. Federal Reserve Board's recent decision

to cut the Fed funds rate by another quarter point to 1.0%, the worry is that the Fed, like the Bank of Japan, may be running out of ammunition to fight deflation.

For what it's worth, most economists dismiss the chances of the U.S. slipping into deflation as remote. According to the Survey of Professional Forecasters conducted by the Philadelphia Federal Reserve Bank, a group of 33 prominent economic forecasters projects the average rate of U.S. inflation over the next 10 years at 2.5%. As shown in Table 1, none of the experts expects inflation over the next 10 years to be below 1.7% per annum.

Although there are certainly some pundits warning about deflation, most market participants appear fairly relaxed about the inflation outlook. For example, the market for U.S. Treasury Inflation-Protected Securities (TIPS) currently projects an average 10-year inflation rate of about 1.8%. That can be calculated by subtracting the yield of 10-year TIPS bonds, which is currently around 1.7%, from the 3.5% yield on regular 10-year U.S. government bonds. No deflation worries there.

According to economist Robert Solow, a Nobel laureate from Massachusetts Institute of Technology, "the probability of deflation actually happening in the United States is so small that the current chatter is a waste of time." One former Fed official recently told a small group, off the record, that the odds of deflation happening in the U.S. were lower, in his opinion, than the odds of the polar ice cap melting next year.

### Will the Experts Be Wrong?

Those are very strong opinions from some very knowledgeable sources. To be sure, there are many examples of experts making forecasts that later turn out to be dead wrong. In this case, however, we would side with the majority view. We think the comparisons of the U.S. to Japan are overdone and we don't think U.S. deflation is a big risk.

### LONG TERM INFLATION FORECASTS

CPI Inflation Rate (%)	
MINIMUM	1.750
LOWER QUARTILE	2.200
MEDIAN	2.500
UPPER QUARTILE	2.725
MAXIMUM	3.500
AVERAGE	2.464

Source: Survey of Professional Forecasters, Philadelphia Federal Reserve Bank

Table 1: Deflation fears are not evident among forecasters. Most believe that U.S. inflation over the next 10 years will come in at around 2.5%. Very few see inflation below 2%.



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The debate is crucial for investors. If the U.S. is headed for Japanese-style deflation, then government bonds will be virtually the only asset class worth owning despite the fact that they already seem overpriced based on many traditional measures. Under deflation, stocks would become a long-term quagmire while cash returns go to zero. Wall Street wags who are obsessed with this scenario are already referring to Fed Chairman Alan Greenspan as "Greenspan-san."

This is not to say that deflation fears won't resurface in the markets from time to time. There is clearly still a great deal of excess capacity in the world economy and growth remains very sluggish. Deflationary pressures can build in that kind of environment, even if the economy is not in outright recession. Many of the most bearish market outlooks we have seen are based not on a forecast of renewed recession, but of a cumulative, debilitating deflation that undermines corporate profits and pricing power amid tepid growth rates.

That said, our reading of the economic tea leaves suggests prospects for stronger growth in coming quarter thanks to the massive amounts of monetary and fiscal stimulus that are now in the

pipeline. Moreover, we think that the comparisons to Japan are inappropriate for a few simple reasons:

1. The U.S. economy is far more flexible;
2. The U.S. financial system is far more robust; and
3. U.S. economic policy is decidedly more pro-growth.

### Economic Flexibility: Advantage U.S.

A former editor of *The Economist* magazine, Brian Reading, once described Japan as "not capitalism with warts, but communism with beauty spots." Allowing for some journalistic overstatement, his point was that Japan's economy was rigged in many ways to keep market forces from operating efficiently. So even after Japan's stock market and real estate markets fell sharply in the early 1990s, companies did not cut costs aggressively and let profits and productivity fall instead. Poor profits led to a long period of anemic corporate investment as well.

In contrast, for better or for worse, U.S. companies have been quick to cut costs in the face of recent economic weakness, leading to a loss of about two million jobs in the last several years. As a result, corporate profits have begun to recover and, by the government's broadest indicator, are now up by 26% since the bottom reached in 2001. Improved corporate cash flow has begun to set the stage for improving corporate spending, and stronger balance sheets have permitted corporate bond markets to supply capital to companies at far more favourable terms than a year earlier.

As shown in Chart 1, the behaviour of corporate profits in the United States in recent years is much better than what Japan experienced in the early 1990s. Since corporate profits tend to lead corporate spending, one can expect a much more robust recovery of corporate spending in the United States than Japan experienced in the early 1990s.

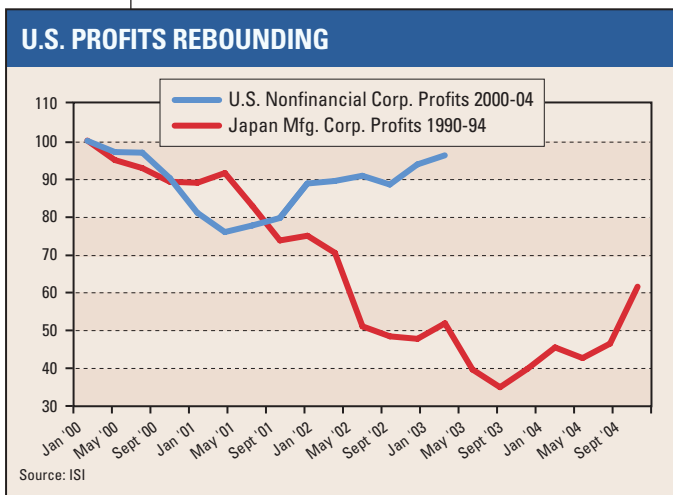


Chart 1: Compared to Japan in the early 1990s, corporate profits in the U.S. have rebounded much sooner thanks to aggressive cost cutting by U.S. companies and better economic policy.



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### Financial System: Advantage U.S.

In sharp contrast to Japan, the U.S. banking system has been healthy in the wake of the three-year bear market in stocks. As economist David Hale has noted, "During this cycle, bank failures have been rare. There were seven in 2000, four in 2001, 11 in 2002, and two so far this year." By way of comparison, there were 474 bank failures in the 1989-1991 period in the United States when weak real estate markets created major problems for commercial lenders and savings and loan institutions.

Although non-bank lending through the capital markets played an important role in creating the boom-bust economic environment of recent years, U.S. banks themselves have avoided major hits. This creates a much better framework for economic revival than was the case in Japan in the 1990s, where bank problems created a chill on credit formation that tended to paralyze the entire economic system. As Hale observes, "If the banking system is well capitalized and profitable, the odds are very high that monetary policy will be effective. It is the resilience of America's banks, not just the monetary policy of Alan Greenspan, which will set the stage for economic recovery later this year."

Hale also notes that the superior profit performance of U.S. corporations relative to Japanese corporations is a reason for optimism. In Japan, for example, heavily indebted companies tend to have rates of return on capital of less than 1.0%. In the U.S., in contrast, the 100 most heavily indebted companies still enjoy a rate of return averaging close to 6.0%.

According to Hale, "All the recent suggestions that the U.S. could be headed for protracted downturn comparable to Japan's are ridiculous because of the divergences in corporate performance. American firms allocate capital more efficiently than Japanese firms. They would also not be prepared to tolerate a decade of asset returns close to zero. Meanwhile, the securitization process has encouraged American investors to write off debt far more quickly than has been the case with Japanese banks."

### Economic Policy: Advantage U.S.

Compared to Japan, both monetary and fiscal policy have been used far more aggressively to respond to economic problems associated with the stock market sell-off.

Since the stock market peaked in early 2000, the Fed has cut interest rates from a high of 6.5% to 1.0% in little more than three years. In contrast, it took the Bank of Japan more than five years to cut interest rates by a similar amount following Japan's stock market peak in late 1989.

As a result, growth in the U.S. money supply has been far more robust since the stock market peak than was the case in Japan in the early 1990s. As seen in Chart 2, the broad stock of U.S. money called M3 is up by more than 25% over the past three years. That eclipses the rate of growth in Japan's money supply following its stock market peak by a wide margin.

Moreover, Fed officials have had the opportunity to study what went wrong in Japan in recent years and have developed contingency plans to avoid a

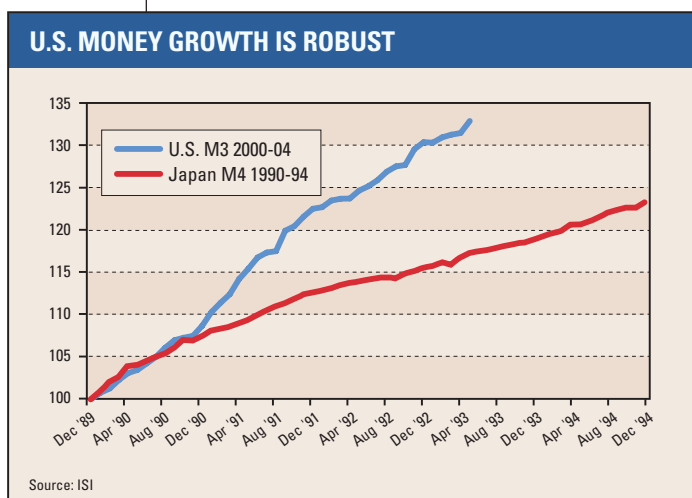


Chart 2: The Fed has cut rates far more aggressively than the Bank of Japan did in the early 1990s. As a result, U.S. money growth is more robust and deflation risks are lower.



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deflationary outcome. As economist Solow noted, "One of the good things that distinguishes Alan Greenspan's Fed from the Bank of Japan and the European Central Bank has been its flexibility, its willingness to think outside conventions." Fed officials have gone out of their way over the last year to educate market participants regarding unconventional weapons they have at their disposal to fight deflation. These include the power to buy Treasury bonds directly or to buy agency bonds or other assets with the Fed's "high-powered money."

Such measures also have been available to the Bank of Japan, but it has not used them. Accordingly, many analysts have concluded that Japanese officials made a conscious decision to permit deflation to develop as a way of creating political pressure for economic reform. If that was the political background to Japan's slide into deflation, there is no comparable political incentive for policymakers in the U.S. to let deflation develop.

Fiscal policy in the U.S. has also been decidedly pro-growth in contrast to fiscal policy in Japan in the early 1990s. As shown in Chart 3, the change in the U.S. budget deficit in the first three years

following the stock market peak has exceeded what was seen in Japan by more than 3% of GDP.

In short, U.S. policymakers are acutely aware of the corrosive effects of deflation on economic performance and are working to prevent deflation. It remains to be seen whether they will ultimately be successful, but we are not inclined to "fight the Fed" when it is so clearly aiming for strong growth ahead.

### Stocks Should Outperform

If U.S. policy is successful in engineering reasonable growth over the next year, the implications for financial markets should be relatively straightforward: Profits should be up by 15% or so, government bonds should sell off, and stocks should be able to rally in line with profit growth.

Further U.S. dollar weakness would not be surprising against this backdrop, since a U.S. recovery would tend to bring in more imports and widen the already large trade deficit.

Therefore, we remain tilted toward equities and away from fixed income in CI International Balanced Fund, with a current mix of 70% equities, 30% fixed income. We also continue to hedge a substantial amount of our U.S. dollar exposure into the Canadian dollar and into other appreciating currencies like the euro.

Our bottom line: We think that deflation will be a no-show in the U.S. and in most other nations aside from Japan. As long as you are not Japanese, there are plenty of other things to worry about in life. Deflation probably should not be high on your list.

Arigato.

William Sterling, Global Strategist  
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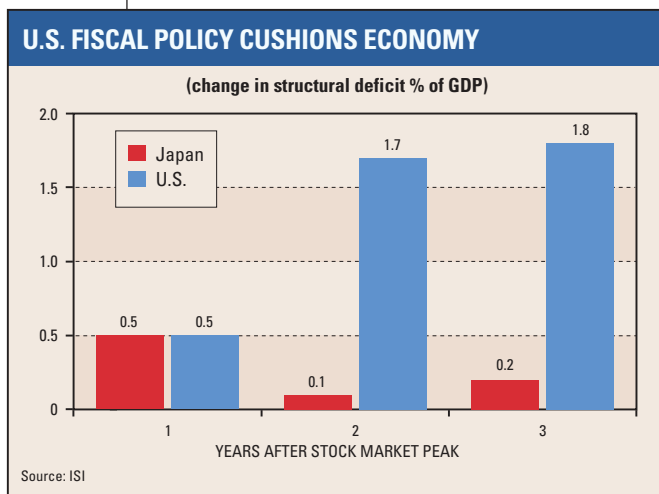


Chart 3: Compared to Japan in the early 1990s, U.S. fiscal policy has been much more aggressive in responding to economic weakness following the stock market decline.