Donald Luskin, Chief Investment Officer
David Gitlitz, Chief Economist

INTELLECTUAL AMMUNITION

Deflation: Early Hopes, and the Metrics of Headwinds

Friday, November 30, 2001

Donald Luskin

After wandering for years on the lunatic fringe of economic analysis, monetary deflation has hit the mainstream -- even ultra-hawk **Federal Reserve Governor Laurence Meyer** is talking about it now. So our forward-looking clients are already asking how to hit one out of the park (and *not* Enron Field, we are sternly warned) when this inning ends for deflation, and re-inflation steps up to the plate.

Well, we're not quite ready to call monetary deflation out just yet, though there are some tantalizing portents that may, in retrospect, prove to have been early signals -- not least of which is the fact that the possibility of deflation has caught the attention of the likes of Laurence Meyer. My colleague **David Gitlitz** thinks that, for those of you who want to risk an early call, the play for a US re-inflation is long junk bonds or the NASDAQ. The play for a Japanese re-inflation is short Japanese government bonds (see "Japan: Opportunity in Chaos" November 27, 2001).

But for those of you not quite ready to swing at that pitch yet, let's spend a few moments learning more about the dynamics of how monetary deflation can impact stocks.

Last week I compared the impact of deflation on two very different companies: **Microsoft** and **General Motors** (see "The Deflation Investor's Checklist" November 21, 2001). One key driver was *debt* -- companies with heavy debt find that they are making fixed interest payments in increasingly valuable dollars, at the same time as their nominal earnings are dropping.

Debt-free Microsoft comes out a winner and debt-heavy General Motors comes out a loser. But what about the market in general? To answer that question, let's look at aggregated data on the 429 non-financial companies in the S&P 500 (for assembling this data, I am very much indebted to a helpful angel in the Equity Research Group at **Morgan Stanley**).

Expected 2002 net earnings for these companies are, collectively, $310 billion -- and the burden of debt service is currently $125 billion (so earnings before interest are $435 billion, for an interest coverage ratio of 3.5 to 1). Assuming that every 1% in monetary deflation reduces both revenues and non-interest expenses by 1% -- and leaves interest expenses themselves unchanged -- we find that net earnings are reduced by1.4%, and the interest coverage ratio worsens by 1%. These effects are totally linear: 2% deflation reduces earnings by 2.8%, and the interest coverage ratio worsens by 2%.

This means that, all else equal, deflation has *two leverage effects*. First, deflation is itself leveraged with respect to its effect on earnings: the drop in market-wide earnings that can be expected for each increment of deflation *is greater than the increment of deflation itself,* on a ratio of 1.4 to 1. And second, for each increment of deflation, the average company becomes more leveraged in the sense that its interest coverage ratio worsens, 1 to 1 with the rate of deflation.

Until the present monetary deflation is stopped and reversed, these are the basic metrics of the headwinds that the stock market faces. TM

http://www.trendmacro.com
don@trendmacro.com
dgitlitz@trendmacro.com

325M Sharon Park Drive #325
Menlo Park CA 94025
Phone 650 429 2112
Fax 650 429 2112

42 Forest Drive
Parsippany NJ 07054
Phone 973 335 5079
Fax 973 335 8016