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MACROCOSM

Deflation Takes Center Stage

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Core CPI prints negative, and the Fed openly uses the "D" word.

Update to strategic view
US MACRO: The reported fall in core CPI inflation is deceptive, reflecting a one-time drop in energy prices. The Fed is massively easy, and seems committed to staying that way and becoming more so. For now, that's a good thing as it rules out the vicious cycle of debt contraction and monetary deflation. Ultimately it will lead to resurgent inflation when the economy stabilizes and the Fed inevitably moves too slowly to shrink its swollen balance sheet. **GOLD:** The gold price has been battered by the headlong rush for dollar liquidity, but it has fallen substantially less than most dollar assets. This indicates that the Fed's extremely easy posture will be effective at staving off a generalized deflation, and positions gold for significant upside on any hint of economic stabilization.
[see Investment Strategy Dashboard]

This morning's negative reading in the October core Consumer Price Index -- a drop of 0.9% on an annualized basis -- will feed concerns that the present credit contraction and recession are inducing deflation. Falling prices, especially of a key industrial and consumer commodity like oil, in some sense is a blessing. But a sustained drop in prices across the economy is a very dangerous prospect. When debtors are urgently trying to deleverage, deflation implicitly raises the real value of their debt and makes its repayment more expensive. The combination of deflation and debt liquidation is a key dynamic in the vicious cycle that perpetuates and worsens recessions -- so a key element in anticipating the depth and length of the present recession is to understand the extent to which deflation will be in play (see "Vicious Cycle Visions" November 10, 2008).

As a purely statistical matter, we caution against over-interpreting October's core CPI results, which were dominated by the one-time effect of sharply lower energy prices on transportation costs. The Bureau of Labor Statistics' methodology does not filter out that effect, despite the fact that the "core" index is supposed to exclude energy. Note that yesterday's core *Producer* Price Index showed a strong *increase*, perhaps reflecting the fact that the simpler process of tracking commodity prices at pre-consumer stages of production is better at filtering out energy effects.

To be sure, there's more than statistical artifacts or energy effects at work here. We can expect prices to fall in a recession, as sellers seek to stimulate flagging consumer demand and to

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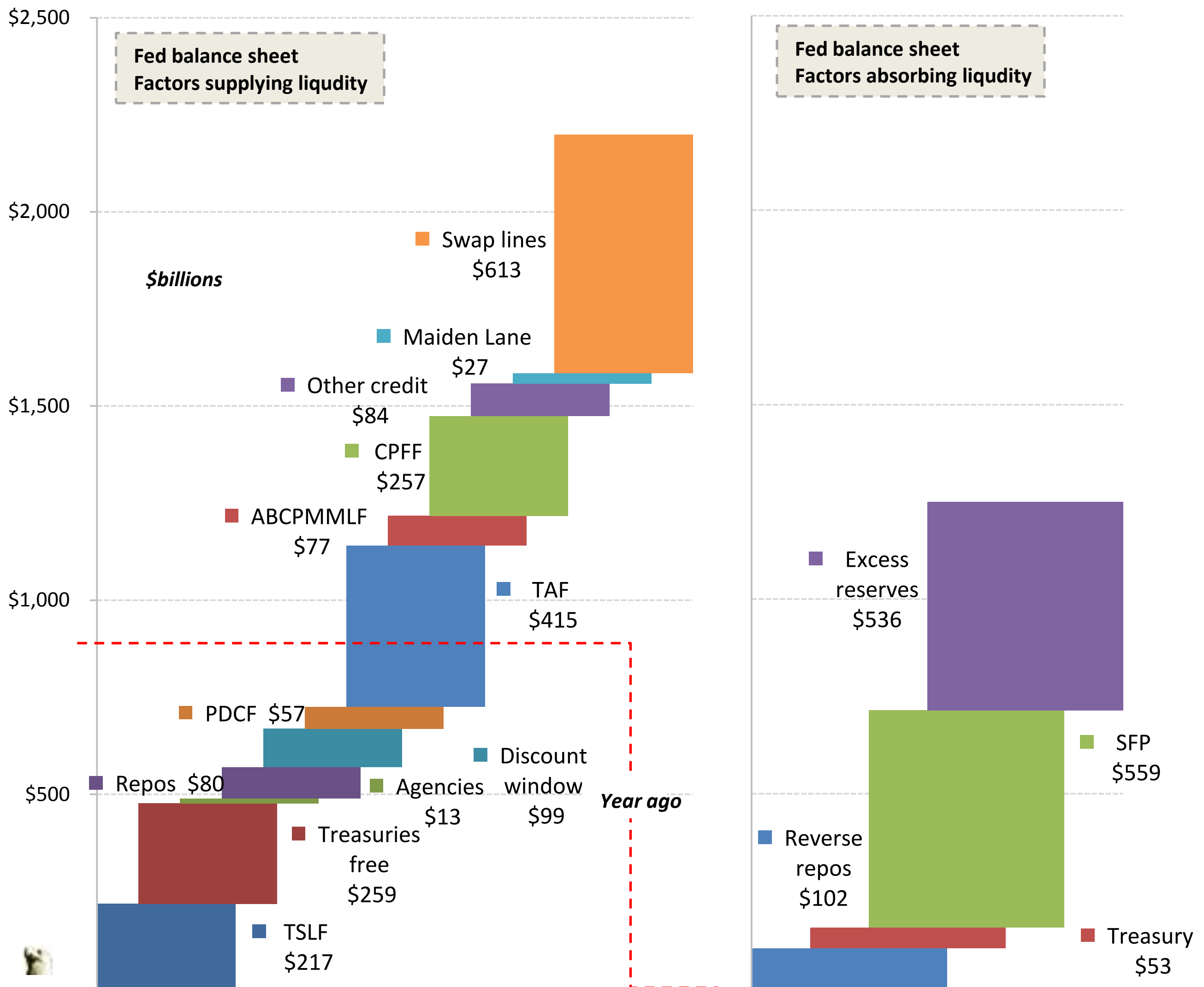
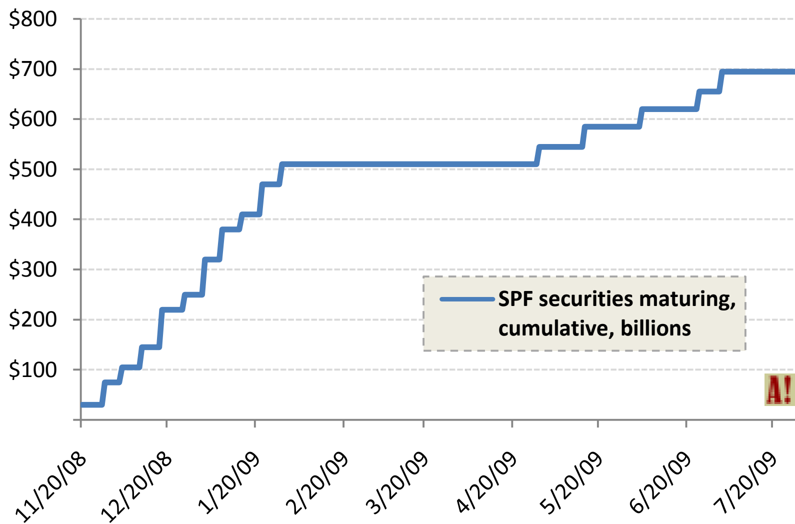


purge excess inventories. But such dynamics are not themselves deflation. For us, "deflation" is a *monetary* phenomenon. Clients often ask us exactly what we mean by that. *Monetary deflation* occurs when the Fed is too tight, when it provides too few dollars, and dollars become scarce in relation to all the things for which it exchanges. Such a policy causes *both* recessions *and* falling prices -- recessions do not themselves cause sustained deflation, and we can point to examples from the stagflationary 1970's when inflation persisted despite them.

The present situation is unique, in that it is the first post-war recession that was not preceded by high real interest rates engineered by the Fed. This recession was caused by shocks to the financial system exacerbated by botched and ultimately counterproductive "rescues" by the Fed, the Treasury and the FDIC -- rescues necessitated in the first place not by tight money, but rather by the legacy of the easy-money policies of the early 2000's that gave rise to the housing and credit bubbles (see "Death by Rescue" November 17, 2008; and "Fear Itself, Volume 2" September 23, 2008). Money is tight now only in the demand-side sense that intensely risk-averse private economic actors are engaged in a headlong rush for dollar liquidity. Money is not tight in the supply-side sense that the Fed is deliberately making dollars scarce.

Quite the contrary -- it's hard to imagine the Fed being any looser. As the chart on the previous page shows, the Fed's balance sheet has grown tremendously in both size and complexity, with a vast array of new liquidity programs having been put in place to meet the needs of distressed credit markets. But the Fed may well get looser still, driven by an intense philosophical aversion to the risk of deflation. We know that Ben Bernanke is a self-professed student of the Great Depression and its monetary roots -- the intense monetary deflation engineered by the Fed of that era. With that lesson in mind, in 2002, with less statistical evidence for deflation than we have today, Bernanke spearheaded the Fed's initiative to take an ultra-easy policy posture to head off any possibility of deflation. The result was a 1% fed funds rate, which was raised grudgingly as the economy recovered. That was instrumental in triggering bubbles in housing and credit, and an outbreak of inflation expressed most vividly in the surge of commodities prices. All that was no doubt more than Bernanke bargained for, but for much of that period he no doubt saw it as a fair price to pay to create a firebreak against deflation.

Here we are again today, only more so. In remarks following a speech this morning, Fed vice chair Donald Kohn referred overtly to the possibility of deflation -- a significant rhetorical ramp-up for the Fed, which until today had talked only about the absence of inflation risk. Kohn also openly used the expression "quantitative easing," effectively admitting that the Fed has virtually abandoned rate-targeting in the present environment (see "1% and So What?" October 29, 2008). This all strongly suggests that the Fed's liquidity posture will now be kept ultra-easy not just to remediate the stress in credit markets, but to actively fight deflation -- which means, effectively, promoting inflation, much as was done between 2002 and 2005.



Pushing in the same direction is the Treasury's announcement Monday that it will reduce the balance of its Special Financing Account with the Fed as the securities in it mature. By the end of January 2009, more than $500 billion will roll off the Fed's balance sheet. Unless that Fed makes some corresponding reduction in the liquidity it provides to the market -- highly unlikely, considering the elevated concern with deflation and continued stress in markets -- every dollar of that represents quantitative easing. Markets have enough to worry about right now, but deflation isn't one of them.

BOTTOM LINE: The reported fall in core CPI inflation is deceptive, reflecting a one-time drop in energy prices. The Fed is massively easy, and seems committed to staying that way and becoming more so. For now, that's a good thing as it rules out the vicious cycle of debt contraction and monetary deflation. Ultimately it will lead to resurgent inflation when the economy stabilizes and the Fed inevitably moves too slowly to shrink its swollen balance sheet. The gold price has been battered by the headlong rush for dollar liquidity, but it has fallen substantially less than most dollar assets. This indicates that the Fed's extremely easy posture will be effective at staving off a generalized deflation, and positions gold for significant upside on any hint of economic stabilization.