

Deflation Hurts, but Stock Returns Can Take It

By Lauren Tara LaCapra

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Consumer prices fell more in October than in any one month in more than half a century, sparking new economic worries in an already shaky market. But while deflation drags down the prices of everything, including stocks, its impact on returns may not be as bad as you think.

There is little question deflation poses several economic challenges, including raising the cost of borrowing for individuals and businesses who are repaying debt -- with interest -- on items that are worth less than they were. Nevertheless, there's an inherent connection between stock returns and inflation that many investors with gloomy sentiment might be overlooking.

According to an analysis by **Gerstein Fisher**, an investment-advisory firm, during the boom time from 1970 through 2007, the typical balanced portfolio posted an inflation-adjusted return of 7%. That's because, despite double-digit stock performance of 12%, inflation remained stubbornly high, averaging 5%.

By contrast, during the Great Depression decade of the 1930s, which was characterized by massive deflation, unemployment and poverty, a similar inflation-adjusted portfolio gained 6%. Quality of life was undoubtedly better during the boom times, but because the Depression included an average -2% change in prices, and investment performance of 4%, returns were just slightly ahead in better times.

"The question we sought to answer," says **Gregg S. Fisher**, president and chief investment officer of the firm, "was, 'Is it possible that if you've got a \$2 million retirement fund, and you're taking \$100,000 a year, with 2% inflation, could it be equally good as with \$2.5 million portfolio, taking \$100,000 per year with 4% inflation?' And the answer was, 'Yes.'"

Few are excited about the potential of an extended deflationary period, which is "a much more devastating type of recession" than the inflationary one of the 70s that came along with oil-price shocks, says Marian Kessler, co-portfolio manager of the Becker Value Equity Fund. Already the effects have been felt by consumers facing negative home-equity and taking hits on their 401(k)s to

the tune of 20%. But that deflation does help boost real returns and ease the burden of high costs for gasoline, food and other consumer goods.

The consumer price index fell 1% in October, just four months after it climbed 1%, so that should be evidence there is no guarantee that deflation is here to stay. The relationship between various economic and fiscal elements have been unsteady to say the least over the past few months, making it difficult to predict where things will go. And a negative change in prices will only help long-term real stock performance if it is sustained.

Casey Mulligan, a professor of economics at the University of Chicago, writes on his blog that deflation can be caused by investors stumbling out of the stock market and into "safer" assets like insured bank deposits and Treasuries. If banks, the Federal Reserve and the Treasury don't provide enough of such assets, consumer prices fall to make those assets more valuable.

While the "flight to quality" has already taken shape, Mulligan notes that banks and financial regulators have already taken significant action to accommodate demand. Banks have taken billions of dollars in additional deposits, the Treasury issuing more notes to fund its bailout initiatives and the Fed taking several steps to boost liquidity.

Mulligan also noted last week that "deflation today is also unlikely because it is much better detected and understood than in was in the 1930s."

"Today, the Federal Reserve and the public have access to consumer price indices within a few weeks of those prices' actually being experienced by consumers.... [and] Federal Reserve officials are also well aware that they have the power to avoid a sustained deflation," he continues.

Of course there are other factors that come into play for investors considering how much money they will earn or lose, and how much it will actually be worth. That's especially as the Obama administration prepares to take office, with promises to boost taxes on wealth and capital gains. But **Fisher** also points to dividends as a silver lining in the cloudy sky of equities.

Many major firms, including Bank of America, Citigroup, KB Home, GM and Ford have slashed or eliminated dividends this year as they grapple with troubled economics. There has been speculation that GE may be next. But **Gregg S. Fisher** notes that over the past 100 years, dividends have remained relatively stable and accounted for more than 50% of profits booked from stock investments.

Says **Fisher**, "Dividends: the rent you get from your investments while you're waiting for things to turn around."

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