

Is The U.S. Headed For A Japanese-Style Deflation?

By: Daphne Gu

The Great Recession of 2008/2009 officially ended in June 2009, with the market staging a massive rally since its low in March 2009. However, for the majority of 2010, the market was directionless, mired with shocks from European sovereign debt and mixed economic indicators, while investor sentiment swung like a pendulum. Inflationary concerns, born of massive liquidity from monetary authorities of the developed world, drove real assets (from commodities to precious metals) to sky-high levels. Conversely, the traditionally lagging indicator of unemployment, stubbornly sitting near nine per cent, has increasingly become a leading indicator of the broad market. Furthermore, the U.S. housing market still has yet to show signs of stabilization, Americans are in the process of deleveraging, and economic growth has panned out to be weaker than what would be expected based on historic norms. Thus, many investors are pondering the possibility that the U.S. might be on the path to a Japanese-style deflation scenario (deflation was a media buzz in the summer of 2010 along with concerns for double-dip in economic growth).

Be it inflation or deflation, price instabilities from both environments are detrimental to fostering economic growth. But deflation is a much trickier situation to deal with from a policy standpoint as:

- it is rare and policy makers have limited experience dealing with it, albeit mostly with success
- for a debtor nation like the U.S., the implication is enormous as what is owed today is paid back at higher amounts, in real monetary terms, in the future

While the U.S. economy faces many challenges going forward, a 'Japanese-style deflation' is still a remote possibility, or at least, a risk that should be monitored instead of being overstated.

The U.S. economy has been through many recessions, during which there was often a fall in the inflation rate. If history offers any perspective, since World War II, recessions have not led to deflation, but rather a lower inflation rate. Over the past 50 years, both headline and Core CPI in the U.S. averaged four per cent. The Headline Consumer Price Index (CPI) calculates the cost to purchase a fixed basket of goods as a way of determining how much inflation is occurring in the broad economy, while core CPI is defined as CPI excluding food and energy prices. The most recent read on headline and core CPI was 1.2 per cent and one per cent, both below long-term averages and generally labeled a low inflation level. Despite the fact that the Treasury market is implying a 2.5 per cent inflation rate (based on the yield difference between treasury and inflation protected treasuries), core CPI is expected to remain at the current level or even trend lower. Over the past 50 years, core inflation has never risen when the unemployment rate is higher than eight per cent. Though not a law of nature, it appears to be intuitive from a labour supply/demand perspective that high unemployment rates will limit wage growth, therefore, translating into lower price growth. Looking forward, growth is widely expected to be 'slow' and 22 months after the official end of the crisis, the recovery does not appear to be as robust as many would have expected.

Aggressive Tightening

In general, most recessions were caused by attempts to reduce a high inflation rate, which were typically tied to the Federal Reserve's aggressive tightening of monetary policy. Thus, as soon as monetary policy realigned, the economy quickly rebounded and moved into the next phase of expansion. The recent financial crisis, triggered by the burst of the real estate bubble, might require a much longer time to recover as balance sheets need to be repaired and confidence rebuilt.

The two main market-moving events in 2010, QE2 and the two-year extension of the Bush-era tax cuts, send a strong signal to the market that monetary and fiscal policies will continue acting forcefully to support

growth. With a Fed that appears determined to inflate growth and drive the market back to risk taking, financial asset prices will continue to be supported for the near term, while long-term, sustained asset prices need to be driven by real economic growth.

Over the long-term, economic growth is driven by innovation and productivity instead of the consumer, and, as innovation drives productivity, productivity drives real incomes.

The U.S. has by far the most competitive labour force in the world. A 2009 OECD analysis shows that the Japanese labour productivity is about 66 per cent of U.S. labour productivity, and there are just a handful of smaller nations that top the U.S. Over the past 20 years, U.S. productivity growth has averaged 2.36 per cent while Japan averaged 1.05 per cent. Since Q2 2009, the productivity growth (yoy) for the past six quarters has averaged at 4.3 per cent, and the U.S. is not showing any signs of weakness in productivity.

The U.S. economy has a dominant advantage over the Japanese economy as productivity gain will prove to be crucial in filling the slacks in economic growth, in particular during periods following recessions. Twenty-two months since the official end of the crisis, lost output during the crisis has been recovered. The U.S. economy is once again at a point to resume growth.

Jobs Lost

It is believed that the U.S. economy lost approximately 8.5 million jobs during the recession. Roughly half of the jobs lost were associated with the construction and banking industries and will likely be gone permanently. Thus far, the economy has added back nearly 1.2 million jobs, which brings a net loss of approximately seven million. Some estimate that it will take multiple years for the economy to absorb the excess workforce, leading to the thought that it will contribute to subpar economic growth as the U.S. economy is heavily dependent on its consumers.

Meanwhile, companies are also reporting that filling open positions in many skilled professions remains a challenge. Some call it 'structural unemployment.' Longer term, those skill sets need to be retrained and ported to new growth industries such as infrastructure building, healthcare, clean energies etc. And when the housing market eventually improves, confidence should be restored and labour mobility regained, contributing to a reduction in unemployment rates.

While U.S. economic growth remains in its early stages after the recession, higher unemployment rates continue to affect average household incomes, which are essential in supporting consumer prices. On the other hand, the Japanese job market is contrary to the U.S. Despite stagnant economic growth, unemployment has been consistently near full, currently at about five per cent. Weak economic growth combined with full employment has translated into low household income growth, in turn driving down prices.

The Japanese economy has a unique domestic/cyclical split. The export-oriented portion of its economy (e.g., autos, electronics) behaves like emerging economies that are driven by the cyclical nature of demand and are difficult to estimate for sustained growth. On the other hand, its domestic economy exhibits more characteristics of a developed economy. Over the past 20 years, the Japanese government has tried various fiscal and monetary tools to revive the economy, but is saddled with a stagnant rate of growth. Since that time, the focus has recently shifted from a heavy focus on infrastructure to a focus on the consumer.

Focus On The Consumer

While the U.S. economy, with about a two-thirds focus on the consumer, is generally more resilient as aggregate demand from consumers is less elastic than an export/cyclical-oriented demand. In addition, channels of growth are much wider. Coming out of the recession, corporate America remains healthy. With a war chest of more than \$1 trillion, it will continue to be an important driver for future growth both in and out of the U.S. Today, S&P 500 companies derive 35 per cent of their revenue from outside of the U.S., of which seven per cent is from emerging economies. The rapid growth in the emerging economies will make its influence greater in the future. Exports have been a traditional path in leading economies out of a recession. Developed economies, including the U.S., are fighting the war on exports as they are much needed in times of weak economic growth. Benefiting from a weaker dollar (regardless of whether it is the intended or unintended policy effect), the export engine of the U.S. will provide an important boost to its economy.

The two-year extension of the Bush-era tax cut package was widely applauded by corporate America, while President Obama pledged to support corporate America to double exports and to continue fostering innovation.

It is often mentioned that the Japanese stock market has not yet regained the peak of 1990 over the past 20 years, which contributes to falling financial asset prices. While the U.S. stock market experienced disap-

pointing performance over the past decade, many are wondering whether something similar could happen to the U.S. stock market. It is crucial to recognize the inherent cyclicality of the Japanese market. The ratio of cyclicals to defensives is 2.9x (47 per cent of the market versus 16 per cent), while in the U.S. it is 0.9x (24 per cent versus 27 per cent) and in the Eurozone 1.2x (29 per cent versus 25 per cent).

Providing Liquidity

Most of the market gains in 2010 were driven by two main market moving events, QE2 and the two-year extension of the Bush-era tax cuts. While QE2 intends to continue providing liquidity and drive the market back into risk taking, the latter is a material boost to growth prospects. As a result of the tax package, U.S. economic growth prospects have been revised upwards, with leading economic indicators pointing to recoveries.

The world is in a delicate imbalance. While the developed world, including the U.S., is fighting low growth to fend off deflation risk, inflation in the emerging economies is rampant. With world economies so interdependent on one another, it will be interesting to see how countries learn to co-exist for an extended period of time. If history offers any perspective into the future, inflation is perhaps still the single most important risk to building wealth. ■

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