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Deflation Risk Review

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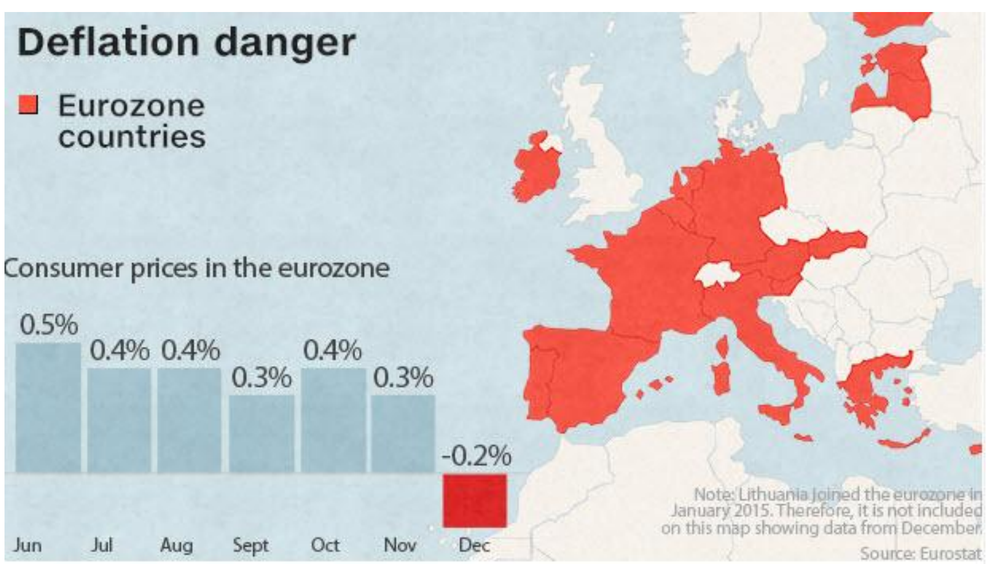
I. What is Deflation?

Deflation is defined as an extended period of falling prices where consumers delay purchases in expectation they will fall further, fueling a damaging cycle of falling production, employment and prices. Some argue that in many cases deflation should not be feared as it is the natural result of a competitive economy that is experiencing productivity gains.

The oil industry is the perfect example of productivity gains as a result of new technology (shale exploration and production). High oil prices fueled both technology innovation and drilling but after several years of excessive production, a massive correction occurred that is now reverberating across many industries – and in countries like Europe it is happening at a time of high unemployment.



Falling fuel and food prices are typically something to be celebrated – unless it results in consumers delaying purchases. This causes GDP to fall creating a vicious cycle that is often difficult to break – just ask Japan who experienced more than 20 years of stagnant or negative growth.
If consumers delay buying decisions because they expect lower prices later, deflation can impact everything from housing and automotive to technology and consumer electronics.

While it is easy to focus on commodity prices as a measure of deflation, one should also focus on wages. Lower commodity prices put more purchasing power in the hands of the consumer but low wages, wage cuts, and layoffs more than offset those commodity gains.

Right now layoffs in the oil industry are the most obvious signs of labor impact in North America – but that is not the case across Europe and many other countries. Low wages, cutbacks and unemployment are a serious problem in many countries. Not only is it creating financial hardship, but it is fueling civil disobedience and Extremism.

II. Positives Aspects of Deflation

In the short term, declining prices of food and fuel boost consumer spending. Consumer confidence is quite high in North America, so lower prices are greeted with open arms. Even in Europe these low prices will (initially) be good for the economy. In the spring of 2014 it cost $44 to fill a 12 gallon gas tank in the United States. In January 2015 it is almost half that.

Diesel fuel is the driver behind the transportation industry but while gasoline is down 35% on average in Canada, it is only down 20% for diesel. It will take a while for Diesel to fall far enough that it impacts the transportation of consumer goods. Most trucking companies impose fuel surcharges that rise and fall with fluctuating diesel prices so the benefits are less transparent. The real advantage to lower diesel prices would be reflected in the mining industry where diesel fuel is a huge cost of doing business. Furnace oil for homes would also benefit from lower diesel prices as the two are closely related.

Since the 2008 global financial crisis, North American low income consumers have seen little to no benefit from the economic recovery. In fact, in many cases it has been a severe hardship. Rising prices of fuel, food, and housing have eaten away at whatever disposable income they may have. A deflationary environment would help them - so long as they didn’t lose their job or benefits.

Investors with cash (or those able to carefully manage debt), would benefit from deflation if it meant they could buy real estate or stocks at significantly lower prices. The challenge is being able to time those purchases so the investor is not caught in a downward spiral.

Low (or near zero) interest rates can be a benefit of deflation but it’s worth noting that Deflationary Japan cut interest rates to near-zero twenty years ago and they are still there. From a consumer and business perspective this seems like a great thing. It is until you read about the many hardships Japan suffered over twenty years.

Japan finally escaped from the grip of deflation in 2013 after their new government created a huge stimulus program with the Bank of Japan - but it has yet to be seen if this was only a temporary fix.

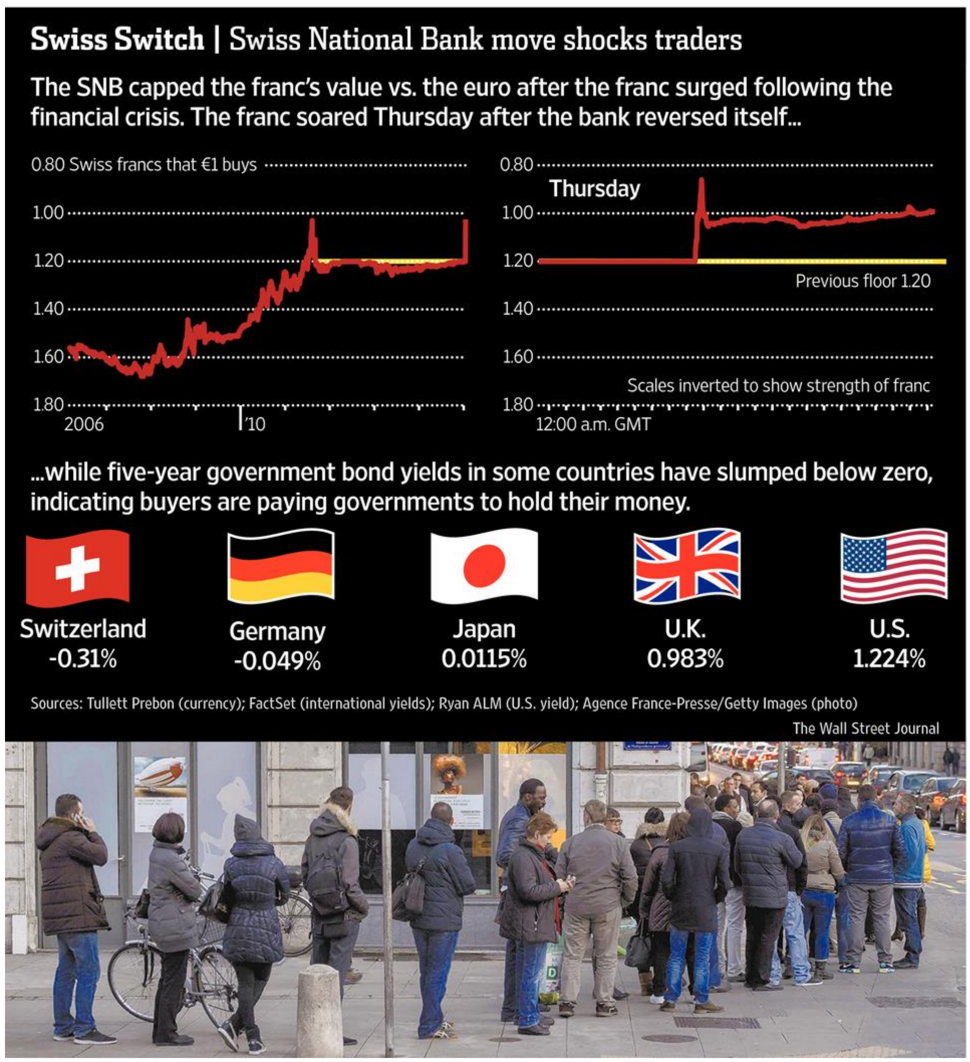
III. Why Governments Need Inflation

Central banks around the world claim that their policies are designed to fuel growth. The likely truth is that they need policies in place that can support (sustain) their massive amounts of debt. If interest rates increase, the government faces a deficit problem that will balloon out of control. If easy credit dries up, then there is a liquidity problem and the demand for their loans (bonds) dries up.

Moderate inflation is critical to government and an environment of deflation causes many problems for governments and large corporations (including flat or declining revenue).

Central banks keep inflation under their control by adjusting key interest rates. If an economy weakens the central bank can reduce the overnight rate charged to banks - which in turn will encourage more loans to be written at attractive rates. During the 2008 financial crisis, central banks dropped interest rates dramatically (near zero) but when that failed to help, they introduced Quantitative Easing (QE) which pumped massive amounts of money into the system - cheap money that fueled growth and high prices.

The problem governments currently face - there is little room left to lower interest rates. In fact, as we recently saw with an "unprecedented" move by the Swiss National Bank, they announced they would allow interest rates on sight deposit accounts to fall to -0.25 percent. They felt the commercial banking system would be forced to seek better returns elsewhere. If Swiss commercial banks transferred money to foreign banks, it would help weaken their currency and make the nation's exports more competitive.



Switzerland showed how quickly (and how desperately) governments can react to abnormal economic situations. Few if any (outside the Central Bank) saw the Swiss reacting as they did. If deflation takes hold across the globe in 2015 and 2016, there is no telling how governments (politicians) will react to protect their interests.

IV. European Forecasts - Five Years of Japan Style Deflation

This Thursday the European Central Bank (ECB) is expected to announce a program of sovereign bond purchases - also known as quantitative easing (QE). This is designed to fend off deflation in the Eurozone and stimulate the economies of member countries. ECB officials insist there is no sign of deflation and oil is the only real problem. Many disagree.

The impact of falling prices can even be seen in obscure industries like dairy production in the United Kingdom (UK). January 20th the BBC reported that many farmers were being forced out of business weekly by falling milk prices (weak demand from China and Russia's ban on food imports). These are situations beyond the control of the farmer but they are impacting producers across Europe. Consumers initially benefit from low milk prices but the negatives outweigh the positives.

QE in Europe is very controversial because the ECB is expressly forbidden under its statutes from “printing money” if it’s seen as a way for governments to get out of debt. Obviously they are managing to find a way around this but Germany, the Eurozone's most powerful member state, is opposed to QE so it will be interesting to see what problems this creates if it goes through.

North America will be impacted to an extent, but no-where near the degree that Europe and developing nations could be impacted. Complicating Europe is their single currency and most believe the Eurozone will be going from bad to worse soon. Unemployment across the region is currently 11.5% but amongst youth (employable under 25) the rate is shocking; Italy 44 per cent, Greece 48 per cent, and Spain 53 per cent.

V. The Worst Case (Doom & Gloom) Scenario

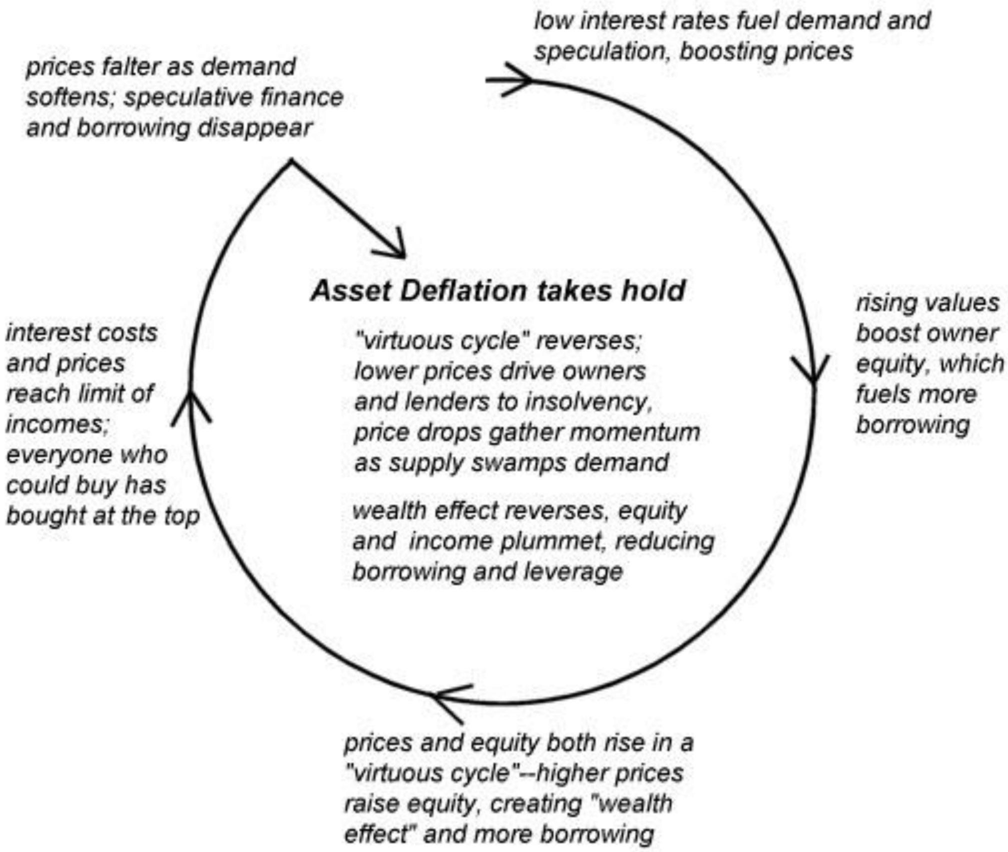
After the financial crash of 2008, there was a very serious threat of rapid global deflation but aggressive interest rate cuts and massive Federal stimulus programs (QE) helped stabilize world economies. By mid 2009 prices began to rebound and easy-money policies began to rebuild confidence.

We are currently in a world of very low interest rates so that bullet has been spent. Should countries ever face another financial crisis of global scale, massive federal stimulus programs are one of the only silver bullets left in their arsenal. There are always repercussions to this.

The worst case scenario from global deflation would see a financial crash that causes consumers and businesses to dramatically cut spending. As demand shrinks, prices fall even further which hurts earnings. This in turn triggers job and pay cuts. It all becomes a vicious cycle.

Should Europe and developing nations fall into this deflation trap over the next three to five years, we would likely see a scaled down version of the above. North America would not be immune from the effects but the odds are better that Canada and the United States would see “mitigated” damage.

One of the greatest risks in Canada would be a hard housing price correction. Canadians carry massive amounts of debt thanks to a real estate market that has not corrected in years. Most in Canada believe such a correction is not possible but if broad based deflation takes hold, real estate will not go unscathed.



VI. Justifiable Skepticism

Americans and Canadians likely find the idea of broad based deflation to be a joke. They see the positive impact that falling oil (fuel) has on their disposable income but they also see how expensive healthcare, tuition, housing, taxes, etc. are. Falling prices for many good and services would be a very welcome change. The difficulty is in understanding how or why it would be a “bad” thing.

To properly understand the risk, one needs to keep an open mind and look at how quickly the price of oil collapsed and the devastating effect it had on several hundred thousand people employed by the industry (both directly and indirectly). There is nothing saying this could not happen to other industries.

Information in today’s world moves at the blink of an eye and financial markets can change just as quickly. As investors we need to be aware of potential risks - either real or perceived.

Many European investors are so concerned about deflation that they are willing to accept "negative" interest rates on short term country bonds - if it means their principal is protected. Yet Lee Ohanian, an economics professor at UCLA (who has written about government economic policies and the Great Depression) says investing in negative interest rate bonds defies logic.

Jeffrey Rosenberg with BlackRock says the dive in European bond yields has more to do with the expectation that the ECB will implement a program of quantitative easing, than it does the fear of extended deflation.

VII. Keep an Eye on China

In 2014 the Chinese economy grew at its slowest pace in 24 years - weighed down by a property market that is expected to lose more momentum in 2015.

Fueled by China's ongoing lending spree (an estimated $14 Trillion in corporate debt), industrial companies are producing far more goods than the economy needs. This applies to both manufacturing and mining - a situation that is creating fierce pricing competition.

Overseas since 2009 there has also been huge investment in mining (iron ore and copper for example) because of China's massive demand for raw materials. Now as demand falls, there is a serious over-supply problem. Chinese stockpiles are bursting at the seams and price competition for raw materials is intense. Large international mining companies are willing to cut prices to keep mines open but this is not a situation that will easily resolve itself without mine closures, wage cuts, or layoffs.

If the problems persist (and they likely will), domestic Chinese companies will need to cut staff and stop or slow wage increases. This would come at a time when the Chinese government is trying to rebalance its economy by moving away from heavy reliance on industrial consumption to domestic / consumer consumption.

China's massive corporate debt is a very serious risk both domestically and internationally. As the government continues to tighten credit, they risk a wave of defaults. China is flooded with companies that anywhere else would be bankrupt, but instead they are able to tap into credit that allows them to produce more and more cheap products. This prevents the "good" companies from growing and turning a profit (the companies that the Chinese government needs).

This situation also hurts companies in other countries that are unable to compete with the Chinese because of price competition and the dumping of Chinese products onto the International market. An over-supply situation that continues to drive prices lower and fuels unemployment.

If both China and Europe were to fall into deflation at the same time, it would create a very serious problem for the rest of the world's economies.

VIII. Deflation's Impact on Stocks

In Canada we have seen the devastating effects of falling commodity prices on our stocks. In 2014 commodities had their worst year since 2008 and junior exploration and development stocks had one of their worst years on record.

For the time being, the natural resource sector is the only (obvious) sign that we're being directly impacted by falling prices. However, under a more serious deflationary environment of negative growth and very low interest rates, we would also see sectors like financials struggle as both consumers and corporations rethink their carefree attitudes toward debt.

Valuation metrics would also change considerably for mid and large cap stocks as year over year revenue growth would take a back seat to earnings and cashflow. Healthcare, discount retail, and dividend paying blue chips would be a few of the areas expected to attract investment capital.

Deflation Can be a Benefit to Micro & Small Cap Stocks

In a deflationary economy, large corporations struggle to grow top line revenue so investors and analysts focus more on the bottom line. Those able to generate a profit in an environment of lower prices and weaker consumer demand will tend to attract the most attention.

Once a risk appetite builds back into the stock market and investors grow tired of weak returns, investors will look for higher growth stories (the rising stars) that will be capable of generating substantial capital gains. These could come in the form of higher quality micro and small cap companies. This may entail high growth industries, drug discoveries in the biotech sector, technology innovation, and important natural resource discoveries.

Gold would hopefully do well (or at least stable) even in a deflationary environment as investors (and Central Banks) should still view the metal as a safe haven.

CONCLUSION

In the past twelve years, the fear (or talk) of global deflation has been seriously considered several times. But now thanks to the collapse in oil, it is being taken very seriously.

Since the summer of 2014, slowing growth in China and severe weakness in Europe and Japan has deepened fears that the global economy could slip into deflation. Those concerns escalated in Q4/14 as oil prices collapsed and investors piled into government bonds - driving yields on some bonds to record lows.

The situation is made worse in Europe, Japan and other countries where the dominant population is aging and they lack the willingness or ability to spend. Combine this with rising tensions and conflicts around the world and investors are looking for less risk and safer places to protect their wealth - even if it means lower returns.

Many investors (both domestic and international) feel the U.S. dollar and large U.S. public companies are a safe bet so that is why we continue to see a flight of capital to the United States. Right or wrong, it is a herd mentality that will be difficult to break.

As investors in small companies and with significant exposure to resource exploration (the huge majority of stocks on the TSX Venture Exchange and the CSE) we need to be well aware of this deflation risk - even if it means to error on the side of caution in 2015.

Cash remains king and for public companies, strong balance sheets will take on critical importance. Excessive DEBT will become a four letter word - companies involved in the oil and gas industry will soon experience this. For junior exploration companies, 2015 will be another year where it will be extremely difficult to raise capital. High quality gold projects should do well and other industries with strong economics (or existing cash-flow) should still attract investment capital.

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