Tiburon Capital Management

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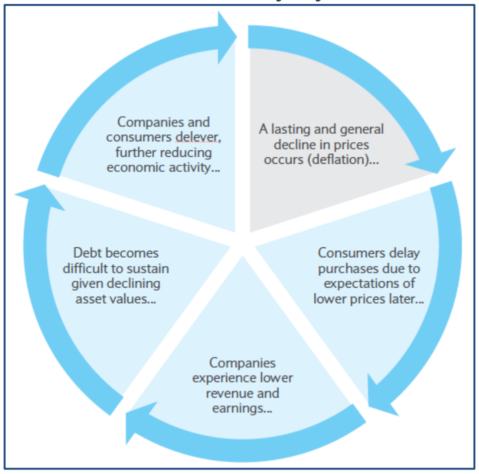
The Deflation Bogeyman

The end is nigh – various anonymous fanatics with placards walking Oxford Street in 19th century London

Investors are correct to worry about deflation because it can have severe negative consequences for stock prices. Deflation causes consumers and businesses to delay purchases because they develop expectations that prices will be lower in the future and debt becomes more difficult to repay. The last time the US experienced lasting deflation, in the 1930s, equity prices fell 80%. The time before that, at the end of the 1800s, equities went 25 years with no gains. A more modern example exists in Japan, but the outcome is the same, with equities falling during the *Lost Decade*.

A Deflationary Cycle



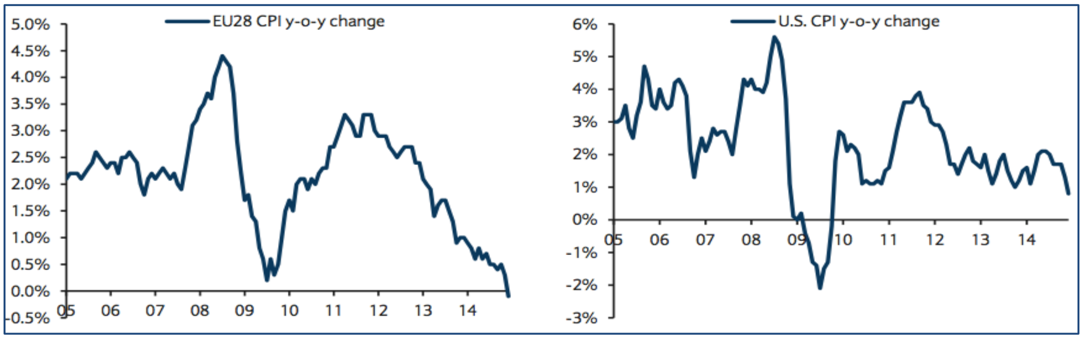
Source: Barclays Research

Deflation and concomitant declining prices, if they persist, generally create a vicious spiral of negatives such as falling profits, closing factories, shrinking employment and incomes, and increasing defaults on loans by companies and individuals. To counter deflation, the Federal Reserve can use monetary policy to increase the money supply and deliberately induce rising prices, causing inflation. Theoretically, today in the US, lower rates longer can counter this and is part of the two reasons we've had the view that *Lift Off*, if occurred in 2015 at all, would be modest.[1] Rising prices provide an essential lubricant for any sustained recovery because businesses increase profits and take some of the depressive pressures off wages and debtors of every kind.

While some economists expect the CPI to turn negative in 2015, this is not presumptively deflationary because it is not indicative of a *general* decline in prices. Rather, what the US is experiencing is a *sector-specific* price decline that is difficult for the energy sector but is, overall, not having negative consequences for the broader economy.

[1] Our *Lower Rates Longer* thesis has been predicated on: 1) the relative strength of the US Dollar versus other currencies and impact of increased rates off the strength of the Dollar; and 2) the Labor Force Participation Rate and Wages – the Fed doesn't often talk about how poorly these statistics are coincident with the present *appearance* of job growth. This, in our view, is changing as we write.

Prices Have Been Declining in Europe and the US

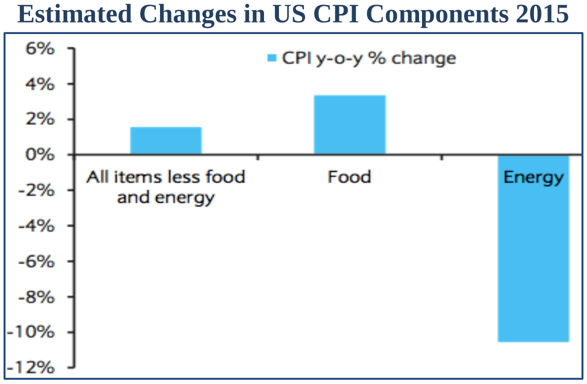


Source: Haver Analytics

The Fallacy of Regarding CPI as an Indicator of Deflation

Ben Bernanke sums it up well: "sector-specific price declines, uncomfortable as they may be for producers in that sector, are generally not a problem for the economy as a whole and do not constitute deflation."[2] What the US is experiencing is clearly a *sector-specific price decline* that is certainly uncomfortable for the energy sector but is, overall, not having negative consequences for the broader economy. The sector-specific nature of price changes is illustrated below, which shows that although energy prices have declined sharply, food and other non-energy prices have continued to go up.

Estimated Changes in US CPI Components 2015



Source: Haver Analytics

Outside of energy, only apparel, used cars and trucks, and airline fare are experiencing price declines. Deflation in airline fare is a direct consequence of lower oil prices. Other categories such as food and medical care continue to experience price increases. Food is up 3%; led by meats, poultry, fish, eggs, and dairy; while medical care commodities and hospital services are up 5% each. Overall, we believe the detail above clearly illustrates the *sector-specific deflation* occurring in the US.

Oil Price and Inflation Correlation – Ramifications for Rates and the Deflation Head fake

Since the peak in the oil price in mid-June, inflation expectations have accounted for about 98% of the fall in the nominal bond yield.[3]

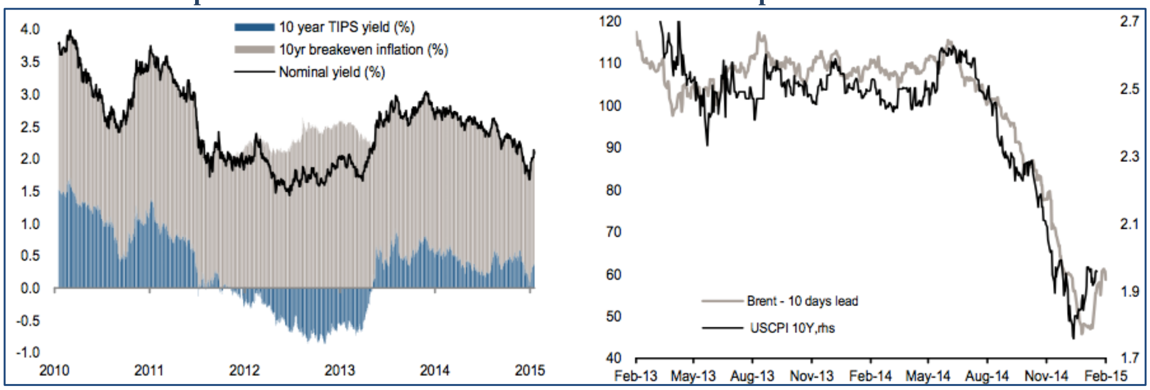
	19th June (%)	Now (%)	Change (bps)	% contribution
TIPS yield	0.39	0.38	-0.01	2%
Breakeven inflation	2.25	1.74	-0.51	98%
Nominal yield	2.64	2.12	-0.52	

Source: Thomson Reuters, Credit Suisse

[2] *National Economists Club* speech, Ben Bernanke, November 21, 2002
[3] *Global Equity Strategy*, Credit Suisse February 24, 2015

The fall in inflation expectations has been very closely correlated to the fall in the oil price. Thus, the market is assuming that the fall in the oil price is a demand side shock when, in our view, it is a predominantly a supply side shock (shale oil, Libya, Iraq and above all, for the first time in nearly 30 years, Saudi Arabia, which controls 85% of spare capacity is overtly pursuing market share as opposed to being a swing producer to maximize price).

Low Inflation Expectations Drive down US Bond Yields...These Expectations Correlate to Oil Prices



Source: Thomson Reuters, Credit Suisse Research

Inflation expectations have started to rise as oil prices have *seemingly* troughed. As the IMF points out, after two years the fall in the oil price should, in their models, prove inflationary. Moreover, in 1985 (the last time Saudi became a price taker not a setter) the US 10 year bond yield troughed when the oil price troughed.

Oil Price Drop Stimulates Developed Markets ("DM") Oil Importing Economies – Growth Should Beget Inflation (Good)

We think that the supply-driven fall in the oil price is an important boost for global growth, and should soon start to have visible effects for oil importing countries. 85% of global GDP is accounted for by net oil importers and 15% by net oil exporters and thus the negative hit from the fall in the oil price is far more concentrated, immediate and visible than the benefits. However, we think the benefit is likely to be substantial, and greater than would have been expected historically, for the following reasons:

- The fall in oil prices is already having an impact on consumer confidence (with the historical relationships between the oil price and consumer confidence suggesting the latter can continue to move higher). Economic models from the IMF suggest the second round confidence effects could be as large as the direct benefit of the fall in oil price to consumers.

- The fall in oil price is redistributing income to lower-income consumers in DM, who in some regions have had their worst 5-year period for real wage growth on record, and thus are likely to spend any windfall gains.

- We do not believe that an economy falls into *bad* deflation when the fall in inflation is largely in the price of non-discretionary products (e.g. oil, food). If non-discretionary product prices are falling while wage growth is not, real disposable income growth rises (e.g. in the euro area wage growth is 1.4%, deflation is 0.5%, and thus real wage growth is rising to 1.9%). Japan has shown even when an economy is in *bad* deflation, consumer savings ratios do not necessarily rise (over the period of deflation, the savings ratio has fallen from 8% to approximately 1.5%).

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The Deflation Head Fake Thesis - Summary

Oil's precipitous price drop is primarily supply-related. Oil price declines and inflation expectations have been highly correlated. Assuming that recent currency debasement via interest rate declines and CPI declines are primarily related to oil price decline – our point of view, *then perceived stability, if not a bottom in oil prices likely portends the end of deflation concerns with the prospect of more generous rate hikes concurrent with a clearly improving economy.*

As we've often written in the past, investors that lived through the carnage of the *Great Recession* have had a tendency to look for and find the latest Black Swans in markets subsequent. Deflation is a great bogeyman for the moment. However a parsing of the CPI suggests that the dramatic oil price declines are the primary reason for a falling CPI. Ironically, reduced oil prices are a tailwind for the majority of DM companies and US. This bogeyman can create volatility in markets between here and whenever market participants and pundits wake up and herd off in a next direction (inflation?). This would come about with the oil price stability or the perception of an oil bottom, continued robust DM economic data or both.

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