

**Tuesday**  
October 14, 2003













vbjusa.com

Serving Vancouver & Clark County Washington, USA - Since 1994

# VANCOUVER BUSINESS JOURNAL

special pubs   circulation   classified   about us   data store

## INSIDE TODAY:

-  Focus
-  Real Estate & Development
-  Banking & Personal Finance
-  Weekly Highlights
-  News Briefs
-  Sales & Marketing
-  Editor's notebook
-  Letter to the editor
-  Week in review
-  News
-  Newsmakers
-  Opinions
-  Publisher's notebook

## DEPARTMENTS:

Advertising 

## Understanding the affects of inflation and deflation

by Guest Columnist  
Guest Columnist

S  
Sea

by Brian Coughlan

With the economy apparently starting to find its feet, fears from the past have been dredged up to give investors something new to worry about.

This latest resurrected fear, known as deflation, has shown its menacing face only a handful of times in the past – the most onerous during the Great Depression in the early 1930s.

Given that deflation has reared its ugly head so infrequently, many investors are unaware of what deflation is; how it differs from its more popular cousin, inflation; and the affects either can have on an investor's portfolio.

Inflation is characterized by a sustained increase in the price level of goods and services. The negative attribute of inflation is that it erodes the purchasing power of a dollar. The same dollar today can buy less products or services as yesterday.

Small amounts of inflation in an economy are acceptable. This can signify that companies have pricing power, which can lead to rising profits, increased wages, which in turn leads to higher levels of consumer discretionary spending.

A study by the Leuthold Group revealed that since 1926, times of mild inflation (as much as 2 percent) have yielded stock returns averaging 15 percent annually.

Unanticipated inflation can affect individuals differently – debtors tend to win, while creditors lose. This is due to a decline in the future value of the borrowed dollar. Essentially, borrowers are paying loans back with cheaper money than the lender expected.

Retirees living off fixed incomes also end up losing, due to a decline in their purchasing power, unless they have a mechanism in place that factors in a cost-of-living adjustment.

Treasury Inflation Protected Securities and government agency step-up bonds may be used to offset inflation. Principal value is adjusted in relation to the Consumer Price Index. Inflation adjusts the principal value higher and deflation adjusts the principal value lower but never below the par value. Step-up agency

bonds offer a step up in the coupon-interest provision, which sets an initial coupon rate for the first period and scheduled coupon increases for the duration of the bond.

Deflation has become the economy's new potential albatross and is experienced when the general level of prices for goods and services in an economy are falling.

Since 1914, the U.S. economy has experienced deflation only 11 times, of which seven instances occurred during or just preceding the Depression. Levels of deflation have varied as well as the effects they have had on the economy.

Data from the Leuthold Group study and Ibbotson Associates (1926 to 1954) reveals that during periods of mild deflation, stocks have performed well. Periods during which deflation did not exceed -2.4 percent had stock performance that was, on average, 23.2 percent. On the other hand, during periods in which deflation was markedly higher, market returns were significantly on the downside.

The data reveals that mild deflation doesn't necessarily correlate with devastating stock-market performance. Deflation is dangerous in certain situations such as in economies (meaning companies) that are highly leveraged.

When prices for goods and services fall, profit margins can become squeezed, forcing companies to increase productivity to stabilize margins, which may lead to layoffs and cutting wages. Companies may become more reluctant to borrow and therefore reduce their investing and business-expansion activities. As Federal Reserve Chairman Alan Greenspan said from Berlin in June, the real concern to the economy is "corrosive deflation." That is a downward spiral in prices, which in turn reduces growth, thus diminishing household and investor wealth.

The current economy, as measured by recent economic data, has been teetering between two different inflationary states, those being inflation at very low levels and disinflation. Disinflation, which is often confused with deflation, is characterized as a slowing of the rate at which prices increase. Disinflation is often experienced during recessions as sales volumes drop and as price increases are unable to be passed on to the consumer.

So what exactly should investors do?

First, don't panic. The U.S. economy is resilient enough to handle small amounts of deflation as our data shows. Investors should base their decisions on the long-term economic prospects rather than short-term gyrations. The likelihood of experiencing a deflationary economy is minimal, and a bout with mild deflation won't necessarily lead to a market collapse. The U.S. will likely teeter between disinflation and low inflation, more likely the latter.

To reduce a portfolios exposure to these adverse pressures, investors should properly diversify their investments. Our policy makers understand the consequences of deflation and are taking an active role in combating it before it occurs.

Brian Coughlan is a portfolio manager with Stellar Capital Management LLC, a private money-management firm specializing in high net-worth and institutional clients, in Phoenix, Ariz. He can be reached at 602-778-0307 or by email at [bcoughlan@stellarmgt.com](mailto:bcoughlan@stellarmgt.com).

You can contact us at:  
**Vancouver Business Journal**

2525 E. Fourth Plain Blvd., Vancouver, WA 98661  
**(360) 695-2442**

AD INFO