INVESTMENT FOCUS

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Fears of Deflation are Ridiculous

Richard M. Salsman, CFA
President & Chief Market Strategist

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Fears of "deflation" are widespread[1] and intensifying weekly. By one account, "the scare word whispered around Washington these days is 'deflation,' which means a falling price level and sometimes implies a stagnant if not *collapsing* economy."[2] The "scare word" also spooks the Fed, which considers printing *more* paper money and monetizing *more* shaky debt, even though, aping the Banana Republic central banks of yore, it has already *tripled* its balance sheet since 2008, and even though currency-gold prices, the world's most sensitive *inflation* indicators, have skyrocketed by 16%-41% in the past year (depending on the currency[3]), and by an average of 26%. In the past, gold price jumps of such magnitude – which always mean a *depreciation* in the real purchasing power of paper money – i.e., *inflation* – has been *bearish* for equities and growth.[4]

There's no deflation in the U.S. today, there hasn't been deflation for more than 50 years, and market signals say none is forthcoming. Even if we were to get deflation, it wouldn't hurt equities, profits or economic growth.

The current anxiety over "deflation," that is, an *increase* in money's purchasing power, causing a *declining* price level, are ridiculous, for two reasons: 1) there's no actual deflation to speak of (nor is it likely to occur in the coming few years, given prevailing public policies), and 2) even if some deflation *were to take hold*, it wouldn't necessarily be bearish for equities, profits or economic growth. We'll address the second issue first and the first issue second, after a preliminary reminder of the *meaning* of terms.

Deflation is an *increase* in the real purchasing power (or value) of money – i.e., an *increase* in what a certain sum of money can buy in terms of *actual* goods and services – which entails a *decrease* in the cost of living (and the cost of doing business), as reflected in a *decline* in the general level of prices and costs. In contrast, inflation is a *decrease* in the real purchasing power (or value) of money – i.e., a *decrease* in what money can buy in terms of actual goods and services – which entails an *increase* in the cost of living (and in the cost of doing business), as reflected in a *rise* in broad-based prices and costs. There's simply no rational reason to fear deflation – i.e., to fear *successively more valuable money*, whether it is held or spent. Most people love to get a "bargain" when they shop, which means they want their money to buy *more and more* stuff – *not less* – as time goes by.

Whether a household is earning an *increasing* level of income or instead earning only a *fixed* income, in *either* case it *benefits by deflation* – that is, by a steadily *declining* cost of living. In both cases, *real income rises*. In contrast, inflation *diminishes* the degree of real gain in a rising income, and *reduces* the real value of whatever a fixed income can buy. It is likewise with businesses, which survive and flourish when they generate *profits*, but stagnate and fail when they suffer sustained *losses*. As long as firms maintain

[1] See, for example, Alan S. Blinder, "Why Inflation Isn't the Danger," *New York Times*, June 21, 2010, BU4; Sewell Chan, "Fed Leaders Show Division Over Deflation," *New York Times*, July 15, 2010, B1; Randall W. Forsyth, "Are the Helicopters About to Take Off? St. Louis Fed President Calls for 'Quantitative Easing' to Prevent Japan-Like Deflation," *Barron's*, July 30, 2010; Sewell Chan, "Within the Fed, Worries of Deflation," *New York Times*, July 30, 2010, B1; Gregory Zuckerman, "Big Investors Fear Deflation: Bill Gross Among Those Bracing for Possible Decline in Prices: 'It's Happening,'" *Wall Street Journal*, August 1, 2010; Paul Krugman, "Why Is Deflation Bad?," *New York Times*, August 2, 2010; James B. Stewart, "Defending Yourself Against Deflation," *Wall Street Journal*, August 4, 2010; Henry Blodget, "Here's Why Everyone's So Freaked Out About Deflation," *Tech Ticker*, August 4, 2010; James Mackintosh, "Why Bernanke is Right to Fret about Deflation," *Financial Times (London)*, August 12, 2010; Henny Sender, Aline van Duyn and Sam Jones, "Pension Funds Look to Dangers of U.S. Deflation," *Financial Times (London)*, August 13, 2010; Paul Krugman, "Inflation, Deflation, Debt," *New York Times*, September 2, 2010.

[2] See Diana Furchtgott-Roth, "Analyzing the Deflation Scare," *Real Clear Markets*, August 5, 2010.

[3] The past year has seen the following increases in currency prices per gold ounce: Japanese yen gold price +16%, Canadian dollar gold price +20%, Swiss franc gold price +22%, U.S. dollar gold price +25%, British pound gold price +32%, Euro gold price +41%.

[4] Prior periods with annual increases of 25% or more in currency gold prices were bearish times for equities: 1972-1974, 1977-1983, and 2006-2009.

101 CROYDON PLACE ▪ DURHAM, NORTH CAROLINA 27713
PHONE 919-942-2419 ▪ FAX 919-338-2652 ▪ RMSALSMAN@INTERMARKETFORECASTING.COM

their *profit margins*, they can prosper *either* during deflation (when the prices they receive *and* costs they pay *both decrease*) *or* inflation (when prices received *and* costs incurred *both increase*). Depending on price-cost trends, it's even possible for margins to *widen amid deflation* and *narrow amid inflation*. When the U.S. inflation rate accelerated sharply in the 1970s, it didn't help profitability but *severely harmed* it.

Many economists presume, falsely, that deflation necessarily coincides with (or causes) a *contraction* in economic output – i.e., with a *depression*. In fact, deflation *by itself* in no way curbs the motive to produce, precisely because it doesn't preclude the maintenance of business *profit* margins. Whenever prices in general decline over the longer-term, costs themselves *also* usually decline, which means profit *margins* (defined as price minus cost), or profitability, necessarily can be preserved. It's the *profit motive* that induces rational managers to boost output. Firms don't exist to provide jobs to workers or to pay taxes to governments – and they don't expand or contract based on *prices alone* or *costs alone*, but on the *relation* between them.

Table One
The Industrial Revolution & the Gold Standard
Freedom & Sound Money Contributed to an Inverse Relationship between Prices & Output 1880 - 1913

	% Changes in:	
Nation	**Price Level**	**Real GDP**
Britain	-10%	101%
Denmark	-8%	197%
France	2%	92%
Holland	6%	101%
Italy	7%	78%
U.S.	10%	203%
Spain	11%	43%
Germany	15%	170%
Portugal	22%	56%
Correlation, Prices & Output:		**-27%**

The deflationary Industrial Revolution. Deflation not only was *common* but also a *bullish phenomenon* in the second half of the 19th Century – the period of *fastest economic growth* in human history. Consider the empirical record during the 3-4 decades between the U.S. Civil War (1861-1865) and World War I (1914-1918). There was a *huge increase in output* (and in profits) in the world's major economies during this period, even as *price levels* increased only *marginally* or even *declined* ("deflation").[5] This was a period of widespread political-economic freedom. Contracts were respected, governments (and their debts) were minimal, taxes were low, and money was sound (i.e., the classical gold standard lasted from 1870 to 1913). In the U.S. during these remarkable decades there was no federal income tax, no central bank, no deposit insurance and no morass of regulatory agencies. Table One shows how, despite *stable or declining* price levels, worldwide economic growth (real GDP) was quite *rapid* from 1880 to 1913 and *inversely* related to *prices* (see the negative correlation of -27%). Average annual "inflation" was only 0.3% in these nations from 1880 to 1913, while growth averaged 3.5% p.a. – a pairing that hasn't been matched in *any* 33-year period *since*. This rebuts the myth that falling prices must coincide with a stagnating or contracting economy. Price levels *declined* in fast-growing nations as Britain and Denmark, and increased only *minimally* amid robust economic growth rates elsewhere in the world. The "worst" inflation in 1880-1913 occurred in Portugal, so it suffered the *second slowest rate* of economic growth, but notice how its price level increased by just 22% in 33 years, an annual average inflation rate of only 0.7%. During these decades the U.S. price level increased only 10%, a mere 0.3% p.a.

If we consult an even *longer* U.S. track record during the Industrial Revolution[6] – the 44 years between 1869 and 1913 – we find that real GDP sky-rocketed by 461% – for an average growth rate of 10.5% p.a. – while the price level actually *declined* by 12%, or -0.3% p.a. Today's anxiety-ridden Keynesian economists would have to concede that this was a long-term "deflation" in prices; worse (for them), they'd also have to admit what their theoretical "models" don't even *permit* them to conclude: that these *deflationary* decades coincided with *stupendous* rates of economic growth (indeed, sustained rates of high growth that haven't been matched since). The only subsequent, long-term stretch of robust U.S. growth occurred during the "Roaring Twenties," when the general price level *declined* yet again. From 1920 to 1929, real GDP in the U.S. expanded by 43% (or 4.7% p.a.) while the general price level declined by 17.7% (-2.0% p.a.). Profits and stocks prices also zoomed during the decade. Again, *deflation was no impediment to robust prosperity*.

Devaluation and the Great Depression. That deflation and economic depression *seemed to have* coincided during the "Great Depression" of the 1930s has caused generations of economists to improperly indict (and fear) deflation. In fact, that debacle was instigated and prolonged NOT by "deflation" *per se* but by a series of wealth-destroying public polices: 1) a deliberate inver-

[5] Data source for European nations: Marc Flandreau and Frederic Zumer, *The Making of Global Finance, 1880-1913* (OECD, 2004). Data source for U.S.: Christina D. Romer, "The Pre-War Business Cycle Reconsidered: New Estimates of GNP, 1869-1908," *The Journal of Political Economy*, February 1989, pp. 1-37.
[6] Christina D. Romer, "The Pre-War Business Cycle Reconsidered: New Estimates of GNP, 1869-1908," *The Journal of Political Economy*, February 1989, pp. 1-37.

sion of the Treasury yield curve by the Federal Reserve, in 1928-1929, 2) huge tax hikes on a broad array of imports, starting in 1930 (the protectionist tariffs imposed by the Smoot-Hawley Act), 3) a massive hike in the federal income tax rate on the rich, from 25% in 1930 to 66% in 1932 (which slashed *in half* their incentive to produce income, since it cut the after-tax *retention* rate from 75% to 34%), and 4) a 41% *devaluation* of the U.S. dollar, in March 1933 (i.e., a one-time massive *inflation*). By devaluing the dollar, the FDR regime made it worth *less* in *real* terms; it raised the $/gold price from $20.7/ounce to $35/ounce, which reduced the dollar's *gold content* (real value) from roughly 1/21st of an ounce of gold to just 1/35th of an ounce of gold (i.e., from 0.04838 to 0.02857). This *deliberate* debasement of 41% in the dollar's real value, a value which had been *steady* over the *prior* four decades – constituted *inflation*, not "deflation."

The only real "danger" associated with deflation is that faced by over-indebted would-be deadbeats. The difficulty lies not in deflation per se but in the choice to borrow excessively, made with the hope of repaying in cheaper (inflated) money.

Although broad U.S. prices indexes (and costs) declined sharply from 1930 to 1934, this was an *effect* of punitive public policies – yet another *symptom* – *not* itself a "cause" of the Great Depression. Punitive policies, each in their own perverse way, invited banks, business and the general public to *hoard* liquid and lower-risk assets, to raise their demand for cash balances, especially in the form of gold, due in large part to FDR's devaluation of the dollar, which boosted the gold price, and his threats to abandon the gold standard and seize private gold holdings. A *rising demand* for money, in the face of a *declining supply* of money (given bank failures and the extinction of *checking deposits*, which comprise most of the money supply) necessarily *raises the value* of money (i.e., *deflation*), as reflected in *falling* prices.

As in the past, under the classical gold standard, businesses today could easily survive and even *flourish* under a mild, slowly-drawn-out deflation, so long as their costs also declined and their profit margins were preserved. But the deflation of the early 1930s was quick and severe, leaving little scope for careful, rational adjustments in commercial-contractual relations among dislocated creditors and debtors. Worse, the Hoover-FDR regimes strong-armed businesses into *not* cutting their main cost – *labor*. Obtuse, Keynes-inspired policymakers in Washington insisted that consumers and laborers (not investors or businesses) drove the economy, and as such, they said wage rates and income levels shouldn't be allowed to fall but instead should be *maintained* at pre-1930 levels, even though this policy would necessarily sabotage *profits,* cause *widespread losses* and generate *mass unemployment*. The Keynesians certainly got what they asked for in the 1930s (not a recovery, but stagnation), yet instead of blaming *themselves* for the market carnage, they blamed "deflation" – the *same* phenomenon which, when mild and prolonged, was a direct *boon to economic prosperity* in 1880-1913 and 1920-1929.[7]

The only *genuine* danger from deflation is that faced by *over-indebted*, *would-be deadbeats*. When money *gains* value over time (as under deflation), the over-indebted face a larger *repayment burden.* They must repay their debt with ever-more valuable money, compared to the (lesser) value of money initially borrowed. In a deflation, the prices (and incomes) one receives necessarily decline, but *the face amount of the debt owed* does *not* decline. This is the "pinch" that deflation ultimately exposes and makes transparent. Joblessness only worsens the debt burden, but joblessness itself follows from excessively high real wage rates (see the 1930s). The real danger (and difficulty) in economic depression lies *not* in "deflation" *per se*, but in two fatal choices: 1) to incur *excessive debt* (often made with the hope of repaying in *cheaper* money, as under inflation), and 2) to demand *excessive wage rates*.

We've issued a number of research reports in the past

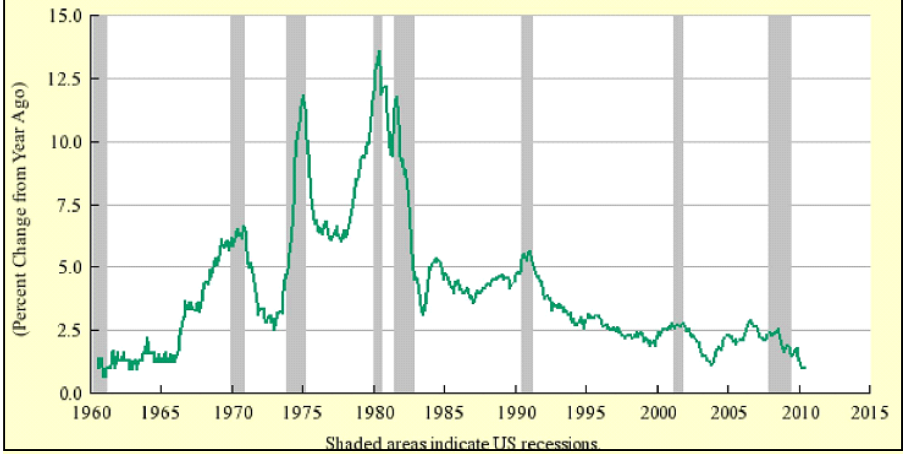
[7] See also Michael D. Bordo, John Landon Lane and Angela Redish, "Good Versus Bad Deflation: Lessons from the Gold Standard Era," *NBER Working Paper 10329*, February 2004. Excerpt: "Deflation has a bad rap, largely based on the experience of the 1930s, when deflation was synonymous with depression. . . . [But] our empirical evidence suggest that deflation in the 19th Century was primarily good" for economic growth and productivity. Source: http://sites.google.com/site/michaelbordo/home2. See also Richard C.K. Burdekin and Pierre L. Siklos, editors, *Deflation: Current and Historical Perspectives*. (New York: Cambridge University Press, 2004).

[8] See "Inflation, Deflation and Investment Returns," *Investment Focus*, December 6, 2002; "Japan Doesn't Need *More* Yen – It Needs a *More Valuable* Yen," *Investor Alert*, March 23, 2001; "The Japan That Few Predicted," *Investment Focus*, October 14, 2005; "A Stronger Yen is Bullish for Japan," *Investor Alert*, October 3, 2003; "Inflation, Inflation Everywhere – But Not a Jot, They Think," *Investor Alert*, February 24, 2003; "Note to U.S. Equity Investors: Deflation is Bullish, While Inflation is Bearish," *Investment Focus*, December 13, 2004; "Depressing Growth, Stimulating Inflation," *The Capitalist Advisor*, February 20, 2009; "Be It Inflation or Deflation, Gold Performs Very Well," *Investment Focus*, July 31, 2010.

[9] John Maynard Keynes, "Concluding Notes on the Social Philosophy Towards Which the General Theory Might Lead," Chapter 24 in *The General Theory of Employment, Interest and Money* (Macmillan, 1936).

decade examining the empirical record of inflation-deflation, especially the ways they affect the economy, profits and investment asset classes.[8] We've found little good reason to "fear" deflation. First, its probability is very low in an era (like today) of *monopolistic fiat-paper monies*, which can be issued by *unrestrained* central banks virtually *without limit*. Second, even if deflation *were* to occur, it's *not* itself bearish. The *real* thing to fear is *punitive government policy*, which invariably includes *inflation*.

Figure One
Have U.S. Retail Prices Declined in *Any* Year During the Past Half Century? No.
% Change in Core Consumer Price Index (CPI), trailing 12 Months
July 1960 – July 2010



At root, unanticipated deflation really only hurts *speculators in leverage* – hardly the kind of people (or businesses) who drive a genuinely productive and entrepreneurial economy. It is *creditors* (i.e., *savers* and *lenders* and *investors*) who benefit from deflation, all else equal (so long as their clients aren't over-leveraged). The so-called "fear of deflation" is nothing but disguised sympathy for over-leveraged deadbeats (or high-cost firms), coupled with a thinly-veiled disdain for greedy lenders, bankers and investors. It's *not coincidental* that in 1936 the Jack Kevorkian-sounding Jack Maynard Keynes called for the "euthanasia of the rentier and, consequently, the euthanasia of the cumulative oppressive power of the capitalist to exploit the scarcity-value of capital"[9] – nor coincidental that in 2009 the Obama Regime jettisoned the U.S. bankruptcy code so as to screw the bondholders of General Motors and Chrysler, for the benefit of corrupt allies at the United Auto Workers.[10] The "rentier" is the presumed dastardly bondholder who lives on his earned interest. He's the "evil" one, according to Keynes, Krugman, Obama. Deflation is to be avoided, while the *poison of inflation* must be inflicted on the parasitic bondholder.

Having examined the *fundamentals* of deflation and its *historic links* to economic prosperity, we turn next to the question of whether there's any real *evidence* of deflation in the U.S. in recent decades, or in the past year or two, and if not, whether deflation nevertheless is a risk in the coming years. Figure One makes clear that over the past half-century in the U.S. (July 1960 to July 2010) *there hasn't been a single one-year period* when retail prices *actually declined*. Not *one*. If there had been such a thing, the scale in Figure One would include a range for *negative* percentage changes. No such range is needed in Figure One. Yes, we can observe higher, moderate or lower rates of *price increase* – that is, varying rates of *inflation* – but we don't see *declining* prices, we don't see deflation, at *any rate whatsoever*. By this criterion, *fears of deflation are ridiculous* – and those who express such fears today have the burden of proving that "it's different this time."

Has the U.S. retail-price inflation rate been *relatively low* lately, especially compared to the *double-digit* inflation rates of 1975-1982? Yes. But does that mean today's low inflation rate is poised to move *lower still*, until it tips "inevitably" into the deflationary zone? Not necessarily – since at *no time* in the past 50 years did a U.S. inflation rate *ever* tumble into a deflation rate. Moreover, the *prior* two cases in which the inflation rate was as low as it is now – in the early 1960s and again in 2004-2005 – the subsequent move wasn't to "deflation" but to . . . *higher rates of inflation*. Indeed, the jump from fairly low rates of inflation in the mid-1960s to the sky-high rates of the late-1970s and early-1980s were associated with a fast-rising gold price and widening budget deficits – just as in recent years. A closer look at the *shaded areas* in Figure One – depicting U.S. recessions – reveals they were *in-*

The so-called "fear of deflation" is nothing but disguised sympathy for over-leveraged deadbeats (or high-cost firms), coupled with a thinly-veiled disdain for "greedy" lenders, bankers and investors.

[10] See "Politicized Bankruptcy and the Mistreatment of Bondholders," *The Capitalist Advisor*, InterMarket Forecasting, Inc., June 9, 2009.

variably preceded by an *increase* in the inflation rate, while post-recession *recoveries* were preceded by a *decline* in the inflation rate (i.e., "disinflation"). Those who now fear "deflation" should instead be *heartened* by the recent *disinflation*, and if anything they should worry about a possible *future rise in the inflation rate*. Again, *fears of deflation are ridiculous – especially* since Washington's *monetary printing presses* are now running *overtime*.

Table Two
Accelerating Inflation Has Been Bearish, While Disinflation Has Been Bearish
U.S., 1960 - 2010

Annual % Changes, 1960-1980 (20 yrs) & 1980-2010 (30 yrs)

Period	CPI	S&P 500	Profits	Real GDP
1960-1980	8.2%	5.7%	12.5%	5.2%
1980-2010	5.8%	26.7%	26.0%	4.3%
Differences:	**-2.4%**	**21.0%**	**13.5%**	**-0.9%**

The core inflation rate peaked at 13.6% in the year thru July 1980

Having visualized, in Figure One (page 4), the history of the U.S. inflation rate over the past 50 years (1960-2010), let's quantify its impact on three key variables: *equities* (the S&P 500), *profits* (from the National Income and Product Accounts, or "NIPA") and *economic growth* (real GDP). As noted, it's obvious from Figure One that there's been *no annual deflation* in the U.S. since 1960, only *different rates of inflation* – periods of faster-*rising* or slower-*rising* prices. The two distinct periods comprise *accelerating inflation* (30 years: 1960-1980) and *decelerating inflation* or *"disinflation"* (20 years: 1980-2010). Table Two tells us that the average annualized inflation rate during the *first* period (1960-1980) was 8.2%, compared to an average annual rate of 5.8% for the *second* period (1980-2010). The performance of equities and profits also has differed materially: stock prices and profits grew *rapidly* during the *low-inflation-disinflation* period of 1980-2010 (+26.7% and +26.0%, respectively), but grew *slowly* during the *high-and-accelerating-inflation* period of 1960-1980 (+5.7% and +12.5%, respectively). Meanwhile, the difference in the growth rates of *output* (real GDP) between the two episodes wasn't significant (+5.2% and +4.3%).

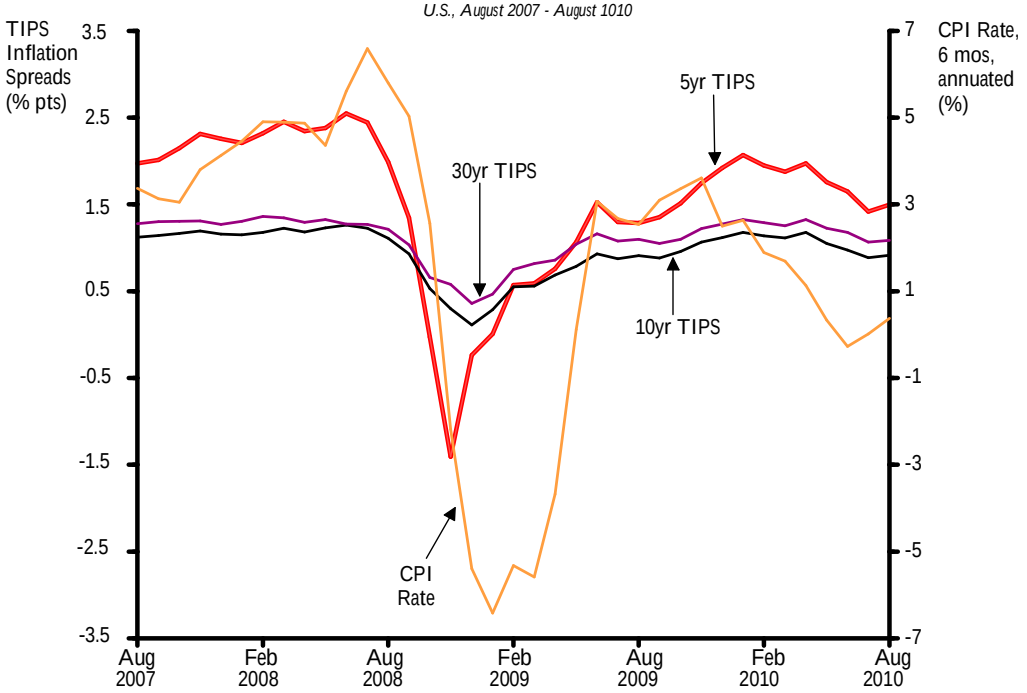
What can we conclude from the combined evidence in Figure One and Table Two? First, deflation itself doesn't tend to occur in modern U.S. history. Second, we're more likely to experience episodes of more or less rapid rates of inflation. Third, profits and equities perform better (or less badly) when the inflation rate is diminishing, and not so well at all when it's accelerating. These empirically-grounded conclusions fly in the face of those so anguished today by "deflation," or even by a declining rate of inflation (disinflation). Yes, we've had a declining *rate of inflation* in the past year, but history says that's *good* for economic recoveries and expansions; the thing to have feared in the past few years were accelerating rates of inflation, like in 2006-2008, since those signaled trouble for the economy, profits and stocks. But investors never hear much from printing-press Keynesians about the potential dangers of a rising inflation rate. All they seem to hear about – continuously and loudly, thanks to the media lapdogs – is whining and worrying about the alleged dangers of deflation. This Keynesian-media bias tends to prompt Fed policymakers into boosting the inflation rate – which is the *real* menace.

So far we've documented that low inflation and even deflation in the period from 1880 to 1913 presented no obstacle to stupendous (and sustainable) rates of economic growth. We've also observed how, in modern times (1960-2010), the U.S. hasn't actually experienced an annual deflation (because money is no longer issued according to the classical gold standard). Finally, we've seen that stocks and profits have grown best while inflation has been declining, not rising.

The message in TIPs spreads. More recent evidence – taken from inflation-indexed T-Bonds – only corroborates these findings. Figure Two (page 6) plots three measures of the TIPs spread (for 5-year, 10-year and 30-year instruments) against the six-month annualized rate of change in the "all-items" CPI (which includes volatile energy and food prices, unlike the series plotted in Figure One). TIPS spreads are a market-based estimate of what the CPI rate might be in the coming years.[11] Figure Two makes clear that this market only *briefly* predicted a forthcoming U.S. "deflation" – and that was only -1.5%, and in late 2008, *nearly two years* ago. Ever since then, the TIPs market has *raised* its estimate of the future U.S. inflation. Thus today's deflation worrywarts are *two years too late* – looking in their rear-view mirrors, as usual. But *not even two years ago* should they have been worried. In fact, *they should have become bullish*, because the short-term (6-month) CPI rate reached its "worst" level (-3.3%) *just prior to the stupendous rebound in U.S. stock prices* (and output) that began in March 2009. Regardless, today's forward-looking TIPs spreads certainly *cannot* be described as signaling "deflation" in the coming few years. By this criterion, as with prior ones, *fears of deflation are ridiculous*.

[11] For more detail and discussion, see "The Continuing Case for TIPS," *Investor Alert*, June 11, 2010.

Figure Two
Market-Based Inflation Premiums
and the U.S. CPI Rate
U.S., August 2007 - August 1010



Some deflation fear-mongers point to the plunge in U.S. T-Bond yields from 4.0% in April to 2.5% more recently as a supposed sign of "deflation." But this yield plunge relates directly to the Fed's seemingly open-ended commitment to a maniacal policy of keeping the over-night, inter-bank interest rate *at zero indefinitely*, together with its "quantitative easing" scheme (debt monetization) – much like the Bank of Japan's futile policy from 1999 to 2006.[12] If the recent yield plunge were *truly* a reflection of dramatically *lower* inflation expectations (let alone "deflation"), we'd see TIPs spreads *narrowing*, whereas in fact they've been *widening* (see Figure Two). Not even in Japan was "deflation" very deep – or the real problem.[13]

Significantly, the 10-year U.S. T-Bond yield also moved *below* 3% and *stayed there* for most of time (97% of the time) during the *two decades* from 1935 to 1955 – yet the U.S. CPI rate averaged a fairly high 3.5% during this period. In all the *other* history (1919-2010, *excluding* 1935-1955), the 10-year T-Bond yield averaged 5.94% amid a *lower* average CPI rate of 2.8%. Thus *inordinately low U.S. T-Bond yields do not necessarily correspond to low CPI rates*. The *radically-low* T-Bond yields of 1935-1955 were accompanied by *much higher* CPI rates than were seen amid periods of higher T-Bond yields. Why? For at least *half* the time (1941 to 1951) – the Fed bought huge sums of war-related U.S. Treasury bills, pledging to keep their yield near 0.375%).[14] This scheme also kept T-Bond yields low. The Fed was *monetizing* Treasury debt – *much like it's doing now*. T-Bond yields today may be low, but they bespeak "monetization," not "deflation." In time, monetization usually generates a *rising* inflation rate. In the year ending with the "Fed-Treasury Accord" of 1951 – when the Fed ceased its pledge to cheaply finance the U.S. Treasury – the CPI rate jumped 9.5%, up steadily from a rate of only 2.7% in 1948. The 10-year T-Bond yield averaged 2.25% during the decade-long scheme (1941-1951), but 3.25% in the decade thereafter (1951-1961).

Let's conclude with a quick review of inflation rates and stock-price performance in the world's major countries since mid-2008 – as portrayed in Table Three. We find

[12] See "Fed Policy Mirrors the Bank of Japan – and Thus Depresses T-Bond Yields," *Investment Focus*, August 20, 2010.
[13] Japan's CPI *increased* by 12.5% in the decade after the NIKKEI peaked in December 1989, or an annualized rate of 1.4%. That was *inflation*, not "deflation." In the *next* decade (1999-2009), which included the Bank of Japan's zero interest-rate policy (1999-2006), the CPI *declined* by 2.4% (only -0.2% p.a.) This was a *mild* "deflation." Did Japan's equities perform badly in each period? Yes – but they declined *less* (-46%) under the *deflationary* decade of 1999-2009 than they did (-51%) under the *inflationary* decade of 1989-1999. As in the U.S., it's *ridiculous* to blame Japan's woes on "deflation."
[14] See Robert L. Hetzel and Ralph F. Leach, "The Treasury-Fed Accord: A New Narrative Account," *Economic Quarterly*, Federal Reserve Bank of Richmond (87/1), Winter 2001: 33-55 (http://www.richmondfed.org/publications/research/economic_quarterly/2001/winter/pdf/hetzel.pdf).

that the median inflation rate was 0.3% in the one-year period ending July 2009, but 2.0% in the one-year period ending July 2010. Not only has there been *inflation* in the world over the past two years, but the rate of inflation has actually *accelerated* (by 1.7% points) from one year to the next.

Again, *fears of "deflation" are ridiculous.*

To explore the impact of recently-changing inflation rates on equities, in Table Three we rank the countries, top-to-bottom, by the extent to which they suffered an accelerated inflation rate. At the top, we can see that Argentina's inflation rate jumped from +5.5% to +11.2% over the past two years, for an *acceleration* of +5.7% points. At the bottom, we find that Russia's inflation rate dropped from +12.0% to +5.5%, for a *deceleration* of -6.5% points. Of course, both countries experienced *inflation* in these years – not "deflation." The U.S. CPI rate was -2.1% in the year through July 2009 only because we use (for comparability) the "all-items" index, which (unlike Figure One) includes volatile food and energy prices; the U.S. index jumped 1.2% in the year through July 2010, an acceleration of +3.3% points.

What's been the *relationship* between CPI performance and equity performance in 2009-2010? Table Three reveals a median equity gain of 12% (in the past year) for the *top-half* of all listed nations – i.e., those which have suffered the largest *acceleration* in their CPI rate. That gain is *below* the median equity gain of 13% that's been generated in the *bottom-half* of listed nations – i.e., those which have enjoyed a *lesser rate of acceleration* in inflation or, better yet, a *deceleration* (disinflation) Viewed regionally, equities in Latin America have performed best in the past year (+25%), thanks to a year-over-year *deceleration* in local inflation rates, from 5.4% to 4.6%. Asia, in contrast, has registered equity gains that were only *half* as good (+14%), in part because it suffered *accelerated* inflation rates, year-over-year (+4.1% points).

However one views the evidence – over however long a time span – *fears of deflation are ridiculous.*

Table Three
A Global Acceleration of Inflation Rates
July 2008 - July 2010

	% TTM: Retail Price Indexes			
Country	**Yr. Thru Jul. '09**	**Yr. Thru Jul. '10**	**Accel./ Decel.**	**Equities (in US$) Yr Thru 9/3/10**
Argentina	5.5	11.2	**5.7**	35%
China	-1.8	3.3	**5.1**	9%
Greece	0.6	5.5	**4.9**	-43%
Thailand	-1.0	3.3	**4.3**	44%
Malaysia	-2.4	1.9	**4.3**	35%
Indonesia	2.8	6.4	**3.6**	43%
Taiwan	-2.3	1.3	**3.6**	9%
Singapore	-0.3	3.1	**3.4**	21%
U.S.	-2.1	1.2	**3.3**	10%
Hong Kong	-1.5	1.4	**2.9**	14%
Canada	-0.9	1.8	**2.7**	15%
Spain	-0.8	1.8	**2.6**	-14%
Venezuela	28.3	30.9	**2.6**	-36%
France	-0.7	1.7	**2.4**	-5%
Sweden	-0.9	1.1	**2.0**	20%
Chile	0.3	2.2	**1.9**	57%
Austria	-0.2	1.7	**1.9**	-12%
Euro Area	-0.2	1.6	**1.8**	-6%
Australia	1.5	3.1	**1.6**	12%
Switzerland	-1.2	0.4	**1.6**	11%
Czech Republic	0.3	1.9	**1.6**	-12%
Italy	0.1	1.6	**1.5**	-14%
Netherlands	0.2	1.6	**1.4**	5%
Japan	-2.2	-0.9	**1.3**	-4%
Britain	1.8	3.1	**1.3**	7%
Denmark	1.0	2.3	**1.3**	16%
Germany	0.0	1.0	**1.0**	1%
So. Korea	2.2	2.6	**0.4**	16%
Brazil	4.5	4.6	**0.1**	25%
Norway	2.2	1.9	**-0.3**	17%
India	11.9	11.3	**-0.6**	25%
Poland	3.6	2.0	**-1.6**	14%
Israel	3.5	1.8	**-1.7**	4%
Mexico	5.4	3.6	**-1.8**	20%
So. Africa	6.7	3.7	**-3.0**	20%
Russia	12.0	5.5	**-6.5**	26%
MEDIAN:	**0.3**	**2.0**	**1.7**	13%
Asia	-1.0	3.1	**4.1**	14%
Europe	0.3	1.9	**1.6**	9%
Latin America	5.4	4.6	**-0.8**	25%
			Median Equity Performance, Top Half:	12%
			Median Equity Performance, Bottom Half:	13%