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From Deflation To Reflation

With the sharp decrease in the value of the dollar, we think the U.S. will be in a reflation process once Iraq uncertainty diminishes. Pricing power should return sector by sector. The pace of the reflation will depend on the stickiness of pricing in a given sector, mirroring the “piece-by-piece” loss in pricing power in 2000-2002. If so, the next U.S. economic phase should be a more normal expansion focused on corporate earnings growth, innovation, business investment, and the pace of interest rate increases.

Fed’s Recognition of Deflation

We think Fed speeches and actions have clearly signaled the evolution from deflation to reflation.

- The December 1996 “irrational exuberance” speech indicated a regime shift in monetary policy to deflation – a Fed policy to fight asset price inflation, implying high real interest rates and an ever-strengthening dollar. Gold and commodity prices fell. Dollar debtors came under increasing pressure worldwide.
- The Fed’s interest-rate-cutting response to September 11, 2001 stopped the deflationary monetary policy.
- The decisive Greenspan-Bernanke speeches in November-December 2002 went further, signaling reflation in our view. “If we ever got to deflation,...there is virtually no limit to the amount of liquidity we could inject into the system” – Greenspan, November 2002. Gold and commodity prices shot higher, mirroring their downward moves in 1997.

Reflation Indicators

Commodity prices and exchange rates have historically been the leading indicators of deflation and inflation. The persistent appreciation of the dollar from 1997 to 2001 and a drop in commodity prices signaled deflationary pressure, followed by a widespread loss of pricing power. A weaker dollar and rising commodity prices are now signaling reflation.

- The price of gold has been rising since late-2001, signaling first an end to deflation and now a move into reflation in which pricing power should gradually return.

Price of Gold



Source: Bloomberg; Bear, Stearns & Co. Inc.

- Industrial metals have followed roughly the same deflation/reflation pattern as gold.

JOC Metals Price Index



Source: Bloomberg; Bear, Stearns & Co. Inc.

The ever-strengthening dollar was a primary factor in building deflationary pressures from 1997 to 2001. It reversed course in 2002. In the past two months, the dollar has fallen more than 5% against a basket of major currencies.

Trade-weighted dollar

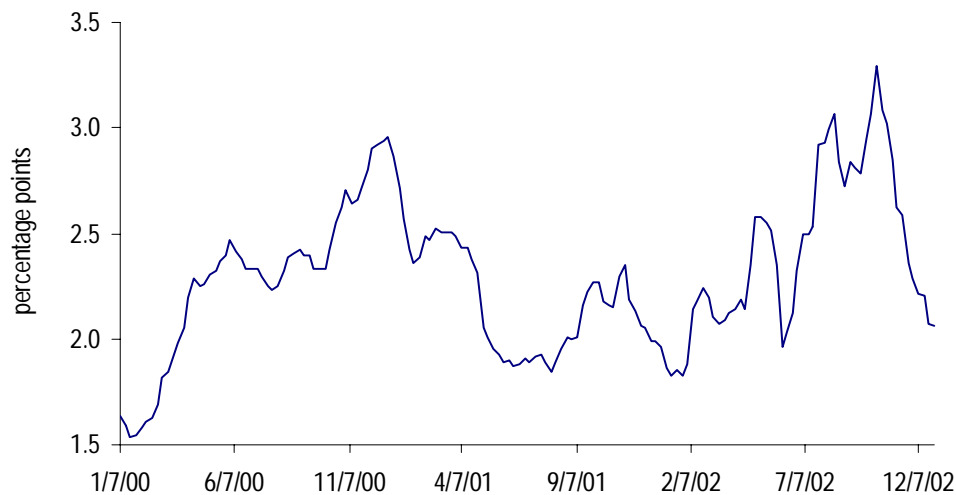


Source: Bloomberg; Bear, Stearns & Co. Inc.

As we have learned from the Japanese experience, deflation decimates the credit-worthiness of private borrowers and is reflected in credit spreads.

- When the markets are concerned over the possibility of deflation, they will increase the spread between yields on corporate debt and yields on Treasury debt of similar maturities.
- The spread between the yields on Treasuries and industrial bonds rose throughout much of 2002—uncharacteristic for a business-cycle recovery. This was most likely a reflection of growing deflation concerns.
- However, since October 2002, this spread has narrowed by more than 100 basis points, an indication of reflation.

Yield spread between 10-yr Treasuries and BBB Industrial bonds



Source: Bloomberg; Bear, Stearns & Co. Inc.

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