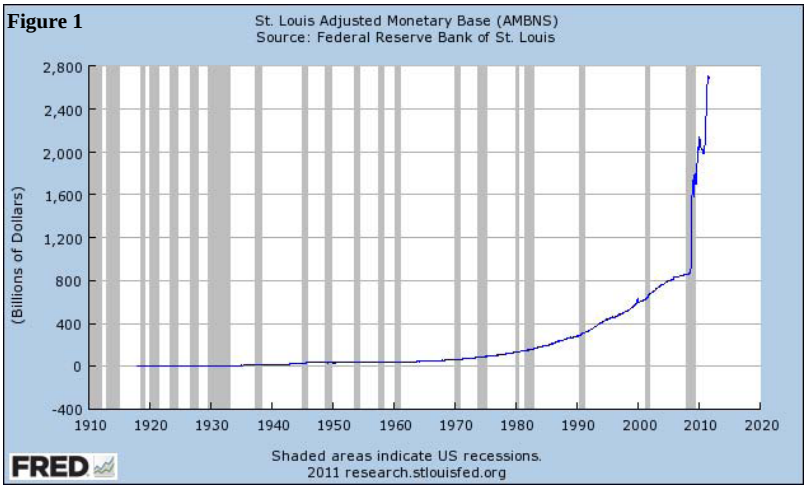
September 30, 2011

Where is the Inflation?
The Deflationary Dilemma

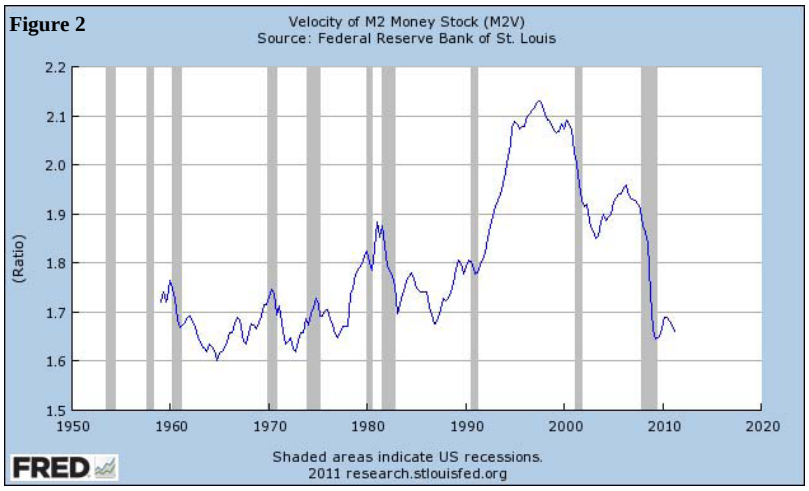
For years, market prognosticators have been warning us about impending inflation, brought on by the cash currently flooding into the system from the Federal Reserve Bank (Figure 1). Even though the short-term and long-term effects of the stimulative efforts known as Quantitative Easings (QE1 and QE2) are too complicated to accurately predict, one is left wondering: where is the projected inflation?



Indications of inflation *can* be unevenly observed in the following places:

- Prices of commodities,
- Wages and prices of goods in emerging countries,
- Foreign currency exchange rates causing fluctuations in the prices of imported/exported goods.

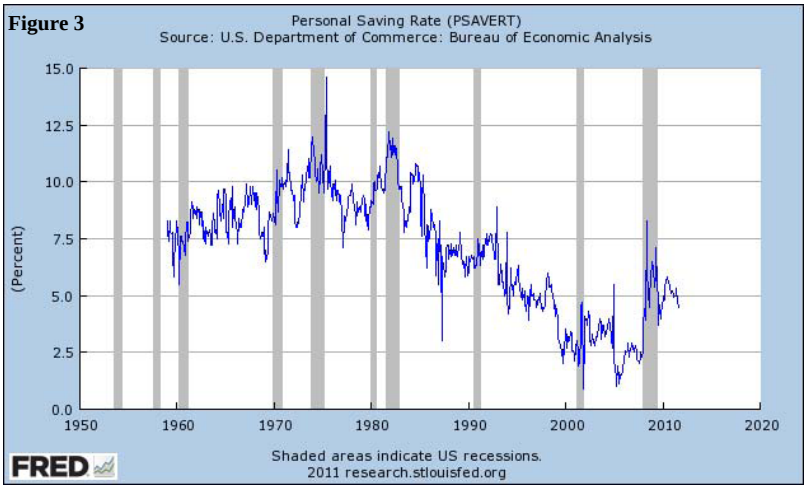
Even though the amount of money in circulation has skyrocketed, signs of deflation are as numerous as those of inflation. This is, in great part, due to the fact that indebted financial institutions and individuals have begun the painful process of deleveraging themselves. This process has caused the velocity of money – how quickly dollars change hands – to drop precipitously (Figure 2). Financial institutions are not handing out loans like candy any longer and they also are not securitizing mortgages and reselling them numerous times. Individuals are reducing and/or defaulting on debts. This deleveraging process is a deflationary phenomenon.



How many years will it take to get back to income-to-debt equilibrium? As a business news commentator recently remarked, "The Fed is holding an Inflation Party, but no one is attending."

Further signs of deflation can be found in asset prices. The process is as simple as it is inevitable. As individuals found their incomes dropping because of market woes and job losses, they were forced to sell homes and other assets to meet cash flow needs. As these assets flooded onto the market, their prices

began to fall as supply quickly exceeded demand. Additionally, as they began to feel the economic squeeze, US consumers became savers rather than spenders. (Figure 3) This put further pressure on prices as demand had deteriorated, deflating prices.



In recent developments, Europe finds itself in a credit crisis similar to the one that started in the U.S. a few years back. As we have discovered, the deleveraging process is a lengthy one that creates falling asset prices, which is deflationary. Although the U.S. dealt with the problem by printing dollars in an effort to stimulate the economy, printing money is not an option that has been considered by the European Central Bank. An adequate solution for the Euro woes has yet to be discovered or agreed upon. While the European Financial Stability Fund (EFSF) is tasked with maintaining stability across sovereign nations it is a bit like herding cats. Europe's inability to find a solution in a timely fashion could cause countries, banks, and, ultimately, the Euro itself, to unravel leading to further liquidity crises around the globe.

In conclusion, the increase of dollars in the system will likely cause inflation in the long term, but the effect of asset price deterioration, the liquidity squeeze caused by deleveraging corporations and individuals, and the Euro crisis will serve to keep a lid on inflation in the short term. If and when inflation does start to accelerate, portfolios that are defensively positioned toward investments that have pricing power will certainly reap benefits.

- *Rachel Wakefield, CFA®*