



Market Comments - Deflation

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Recently, we have had a number of inquiries and comments about the likelihood that deflation is possibly more of a threat to longer-term economic stability than inflation. This is an extremely difficult call, one that economists have argued about forever, and the rhetoric has heated up over the last year or so as the world is trying to recover from the recession of 2008 - 2009.

Deflation is loosely defined as a general decline in prices, caused by a reduction in the supply of money or credit. Deflation is often associated with persistent and rising unemployment resulting in falling demand for goods and services - the opposite of inflation. In spite of all the press this issue has been getting lately, we at The Trust Company do not think that deflation has a high probability of developing now. This is primarily because the world is functioning more and more in some sort of economic concert and in other parts of the world there is tremendous demand for goods and services. While demand may be weak in many parts of the world, it is vigorous in developing markets and that demand has an effect on all other markets.

On the subject of markets and all of the ongoing rhetoric about economic recovery, again there is very little agreement as to probable outcomes among analysts, economists, strategists, etc. In fact, economic activity around the world may be in a "sweet spot," where inflationary pressures are about equal to deflationary forces and, as a result, economic activity will limp along at very low levels. There are all kinds of descriptions of this sort of environment - I am sure you have heard them all - growth recession, stagflation, even double-dip, and many others. We believe that the world is likely to experience slower growth for some time, and basically continue to muddle through in the aftermath of the very difficult 2008-early 2009 period. As we have said previously, this means that expected returns may be restrained as well for some time - not necessarily bear markets, but just lower returns compared to historic levels. Unfortunately, much of this depends upon policy makers,

government, and central banks, and assuming that this trio of institutions will always “do the right thing” may be a mistake.

We have commented before about the importance of addressing and confronting the massive amount of debt that overhangs many developed countries. What went on in 2008 and into 2009 in terms of monetary and fiscal stimulus gives new meaning to the term “priming the pump.” In the U.S., public debt has reached historic proportions - the Congressional Budget Office recently reported that the Federal debt will amount to 62 percent of the nation’s GDP by the close of the 2010 fiscal year. This ratio has exceeded 50 percent only once before: during and immediately after World War II. There are varying estimates of where this is going - the worst has debt reaching 90 percent of output by year 2020. The CBO points out that rising debt will increasingly restrict the ability of policymakers to use fiscal policy to respond to unexpected challenges and to responsibly manage the affairs of government. Eventually, this issue must be addressed but, as in the past, periods of substantial de-leveraging will be characterized by lower levels of returns.

While the world struggles to gain some momentum toward economic recovery, we are likely to face periods in the intermediate future where markets move sideways. These periods will try the patience of long-term investors. In this type of environment, we continue to feel strongly that investors should stay invested in the market, albeit with very close scrutiny on the quality of holdings - both equity and fixed income. The longer world markets successfully discount the very difficult environment of the past few years, the more attractive valuation levels become. This is true today, and most asset classes have been marked down to unusually low valuations. For this reason, we believe it is important to stay in the market.

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