CORE Comments
ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

January 28, 2003

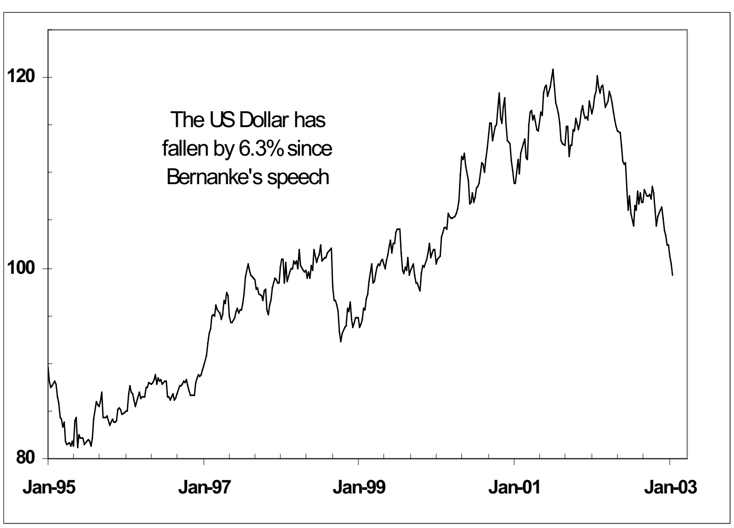
# DEFLATION, THE FEDERAL RESERVE AND INVESTMENTS

In a recent speech by a governor of the Federal Reserve, the Fed declared its absolute intention to use its enormous and varied powers to prevent deflation--i.e., falling prices. This unusually clear statement of future actions by the Fed has profound consequences for inflation, economic recovery, and for the values of a variety of investment assets.

*A primary effect of the Fed's reflationary policy is the decrease in the value of the dollar against other major currencies and the increase, in dollar terms, of foreign (non-dollar) bonds.*

Two years ago, in January 2001, the Fed first began to cut interest rates. The stock market had peaked in March 2000, and had already begun its descent. The economy was beginning to weaken and credit conditions made it difficult for some troubled but important corporations (Lucent and Xerox, for example) to obtain credit. After two years and a dozen interest rate cuts, inflation is extremely low, economic growth is weak, unemployment is rising, and the stock market is prostrate. Had the Fed cut short-term rates from 6.5% to 1.25% at any other time in the last two decades, it is quite likely that inflation would have risen and the economy would have grown strongly. Because this has not come about, the members of the Federal Reserve Board appear to have concluded that deflationary forces--the risk of falling prices--are strong and dangerous.

In the two decades after Paul Volcker became Fed chairman, the Federal Reserve waged a ceaseless and entirely successful war to subdue inflation. During the late nineties, three tremendous bubbles inflated: stock prices, capital spending by corporations on information technology equipment and software, and indebtedness by corporations. The bursting of these bubbles has exerted powerful downward pressure on prices and has restrained economic growth. By November 2002, Alan Greenspan and other members of the Federal Reserve concluded that inflation was no longer the enemy. The Fed finds that the risk of deflation is unacceptably high, and that it must take action to prevent its occurrence.




**By:**

***John N. Mayberry***

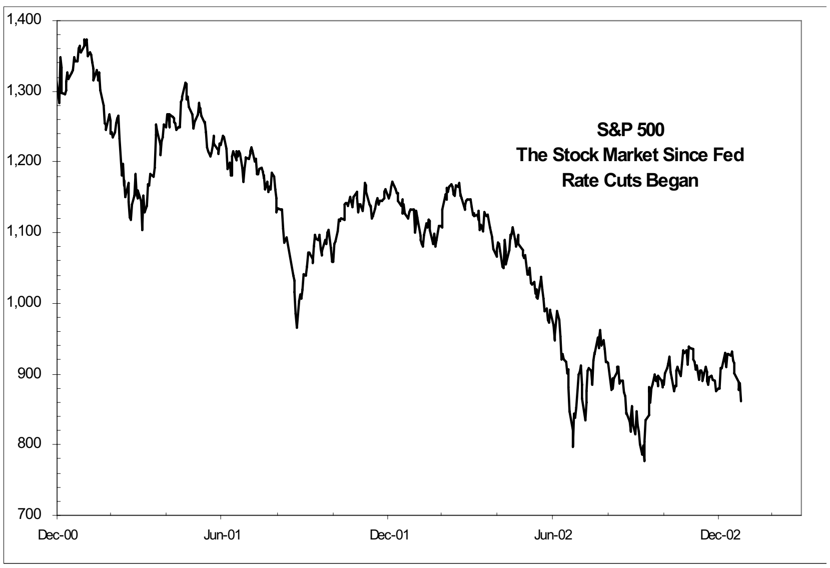
The Depression of the 1930s was accompanied by falling prices to the ruin of debtors, for whom the real cost of debt service (paying interest on loans) and debt repayment rose sharply. The last decade in Japan, following the collapse of its real estate and stock market bubbles, has been one of persistent economic weakness and periodic bouts of deflation. In a speech on November 21, Federal Reserve Governor Ben S. Bernanke laid out the risks of deflation. He referred to monetary policy mistakes of the Federal Reserve in the thirties that worsened deflation, and he stated that the Fed would assure that deflation would not occur in the United States. The title of his speech is unambiguous: "Deflation: Making Sure "It" Doesn't Happen Here". (This speech may be read on the Fed's website: www.federalreserve.gov/boarddocs/speeches/2002/20021108/default.htm.)

## The Fed's Tools

Recall that at the time of this speech last November, the Fed had just cut the rate on Federal Funds by 0.50% to 1.25%—not too far from 0%. Recall also that short-term interest rates in Japan have been near zero for some years, and that Japan has suffered from persistent recession and occasional deflation. With rates so low, there is widespread concern that the Fed has run out of ammunition to stimulate economic growth. Governor Bernanke addressed this directly.

*The Fed is ready to buy US and foreign government bonds if needed to combat falling prices and to stimulate demand.*

Bernanke stated that the Fed has the power--and the will--to use any or all of four different tools to prevent deflation or to end it if deflation should occur. These tools involve injecting a sufficient amount of money into circulation to reverse deflation, i.e., running the printing press. The specific actions include (a) unlimited (Bernanke's term) Fed purchases of longer-term treasury notes and bonds, (b) purchases of government agency securities (e.g., Ginnie Maes), (c) zero-percent loans to banks collateralized by bank loans to corporations (in effect, direct purchases of private debt), and (d) Fed purchases of foreign government loans. Without going into the details Bernanke gave of the tools available to accomplish reflation, I simply quote his statement of the Fed's powers and intended action:




"The Congress has given the Fed the responsibility of preserving price stability (among other objectives), which most definitely implies avoiding deflation as well as inflation. I am confident that the Fed would take whatever means necessary to prevent significant deflation in the United States and, moreover, that the U.S. central bank, in cooperation with other parts of the government as needed, has sufficient policy instruments to ensure that any deflation that might occur would be both mild and brief."

I commend to your reading Mr. Bernanke's entire speech, an extremely interesting document. Note the reference in the quotation above: "in cooperation with other parts of the government". The fiscal policies of the government strongly support the reflation aims of the Fed's monetary policy. Ever-widening budget deficits and tax cutting policies of the Bush administration are both stimulative and inflationary.

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## The Investment Implications of Reflation

Fed Governor Bernanke has given investors a road map. The general intent and effect of this reflationary policy is the restoration of economic growth and the avoidance of a severe, deflation-induced recession of the kind plaguing Japan these many years. In light of these announced policies, we can have more confidence—in time—in the strength of the economy, higher corporate profits and improving commercial real estate. In the shorter term, we can expect a weaker dollar—especially against the euro—and higher commodity prices.

Governor Bernanke outlines prospective Fed purchases of 2 year to 6 year US treasury securities and of the bonds of foreign governments. Additionally, Bernanke discusses steps by the Fed "to influence directly the yields on privately issued securities," i.e., commercial paper and corporate bonds. In plain terms, Mr. Bernanke indicates that, to prevent deflation and stimulate the economy, the Fed will cause the dollar to fall in relation to other currencies, will keep treasury note and bond yields low, and will support corporate bond prices.

**European government bonds will continue to gain in dollar terms.** As I read this speech, the Fed actions described by Governor Bernanke lower the risk and increase prospective returns for investors in bonds issued by European governments. We have made large investments over the last year in these bonds, in some cases directly, in other cases through the American Century International Bond fund. Because the dollar has fallen in price against the euro and because the yields on those bonds has fallen, we have earned double-digit returns on this investment since our initial purchases last spring and summer.

The tide of foreign investment in dollar-based assets is ebbing. The central banks in China and Russia recently announced that they are shifting portions of their reserves from dollars to euros. Reports from Japan indicate that private investment flows to the dollar are declining while flows into the euro are increasing. These actions, and many similar ones around the world, are causing the euro to gain in strength.

In effect, the Fed has declared victory in the twenty-year war against inflation, and announced that it is reversing strategy to inflate the prices of certain assets. Thus, the two-decade bear market in gold is over; this implies that gold's recent price increase from $280 per ounce one year ago to $369 per ounce today is not merely the result of geopolitical jitters. Further, it suggests that when political tensions in the Middle East abate, gold will still gain against the dollar. Likewise oil prices will probably increase, even from today's high levels. Consider that India, China and the Southeast Asian countries, whose economies are all growing rapidly and whose populations collectively far exceed two billion, consume less oil as a group than the United States, with its 280 million people. Will demand for oil grow in coming years? Pretty likely.

## Investment Strategy

*The announced policy of the Fed will cause the dollar to decline further against the euro and will cause our holdings of European government bonds to appreciate further.*

*We intend to increase your investments in these bonds.*

Commercial real estate will benefit from the Fed's reflationary policy. Because almost all commercial real estate employs debt, deflation would be a crushing burden for real estate. A moderate degree of inflation and of economic growth is a benefit to real estate. Since the new year began, REIT prices have fallen by a few percent, perhaps because of the uncertainty around the Bush proposal about taxation of dividends. At this writing, REITs generally trade at a discount of about 10% to the underlying value of their holdings. Although REIT earnings are likely not to grow this year from 2002 levels, the high dividend payments are safe for the better managed REITs. Prospects are good for returns in the range of 6% to 10% this year.

**US Bonds and Stocks.** The Fed's November rate cut and the subsequent policy discussions give strong assurance that low interest rates in the US will continue for many months, if not for the whole of 2003. US bonds will probably continue to perform well in 2003, especially corporate bonds. (We recently sold the US corporate bond fund we have held for some time, Dreyfus Short-Term Income Fund and purchased Pimco Total Return to replace it. The funds have similar objectives and risk levels; the Pimco fund has been producing better returns.)

The stock market is another story. Astonishingly, 2002 was a worse year for stocks than either 2000 or 2001. But, despite already large declines from the bull market highs in early 2000, many sectors of the stock market remain overvalued in historical terms. Couple this with expectations of a weak economy and considerable geopolitical risks, and one must conclude that risk remains high in stocks, higher than warranted by potential returns. Core's investments in stocks remain quite low and we are in no hurry to increase stock investments while bond investments generally and euro bond investments in particular are so attractive.

*Oil and gold prices will probably rise. Commercial real estate and REITs will benefit from moderate inflation.*

**Conclusion.** For two years, I have been writing of alternative investments and Core has been investing in them. These investments—in non-dollar bonds, REITs, and others—have been winners. Further gains lie ahead. Throughout this period, we have been sellers of stock investments, but, to the extent we have held any, these have been losers. Risk in stocks remains high; we will follow the Fed's guidance and invest in other and safer assets.

*Interest rates on US bonds will remain low this year. Corporate bonds will probably do better than treasuries.*

*The US stock market remains risky. There is a reasonable chance that US stocks will decline again this year.*

## Your Financial Situation

We continually reassess client portfolios in light of ever-changing investment risks. We make our judgments based upon what we understand to be your situation. Although we meet and speak with many clients, I fear that we may be unaware of changed circumstances or changed plans for some clients.

Please contact us if you wish to discuss how our portfolios and the complex investment environment can fit together to help you meet your goals with the minimum amount of risk. (You may reach us at 800 451 2240 or by email to me: JNMayberry@coreasset.com.) As I attempt to show in this letter, there are investments that offer low risk and good returns, even in this difficult period.

*Please contact us if there are changes to your personal financial position.*

*We will explain our various portfolios and will make recommendations to meet your goals with the minimum level of risk.*

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