Global Deflation – what are the risks?

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Global Deflation Risk

- How it could happen
- The relationship between stock market movements and deflation
- Risk implications of global deflation for businesses and individuals
Inflation vs deflation

Inflation is a general increase in prices and fall in the purchasing value of money.

Deflation is a sustained drop in the general level of prices.
How could deflation happen?

- Debts in many countries already high.
- Higher debt levels lead to higher interest rates.
- Irrational exuberance in the stock markets leads to crash.
- High debt but equity goes down.
- Default and deflation spiral.
Causes of deflation

- Countries default
- Debt borrowing maxed out in many advanced countries
- Excess use of derivatives
- Excess use of leverage
- All upside considered with no downside
- Inadequate risk management
Large Financial Institutions

Points raised by Nouriel Roubini and Nassim Taleb about large financial institutions:

- Too big to fail – now even bigger
- Mark to market suspended
- Culture of bonus
- Asymmetrical risk
- Privatising of profits and socialising of losses
- Deleveraging still to take place
Financial Crisis

- 1981-1982 major money centre banks insolvent
- 1991 Savings and Loan crisis
- 1998 LTCM (Long Term Capital Management)
- 2007 collapse of the large financial institutions
Lessons from history

Country defaults happen several years after recessions.
Growth of Debt

World credit market debt has increased from $80 trillion to $200 trillion in the last 10 years.

(Source IMF)
PIIGS in Europe

- Portugal
- Ireland
- Italy
- Greece
- Spain
United States

- Total public-sector debt (including state and local debt) is already nearing the 119%-of-GDP (economist Kenneth Rogoff)
- Social security, health care and other costs of c$45 trillion is not provided for and is 350% of GDP.
- USA Inc. has a net worth of negative $44 trillion. That comes to $143,000 per capita. Negative. (Business Week 28 Feb 2011 issue)
Japan Deflation

- The interest rate has been near zero, yet the stock market has fallen 80%.
- Debt to GDP is already over 200%.
- Interest payments and social security spending alone are already higher than tax receipts.
China

• The city of Ordos, was built for 1.5 million residents, and it is largely vacant. China has second-largest shopping mall – the South China Mall which is largely vacant.

• China housing prices are over 8 times average annual income. In Japan, at the peak of the housing bubble (late 80s), that ratio peaked at around 9. In the US in 2007 it peaked at 6.4.
Stock market and deflation

- There were 22 recessions in the 110 years until 2010.

- The United States stock markets has suffered two major deflations/depressions from 1835 to 1842 and 1929 to 1932.
Chart courtesy: SuperCharts by Omega Research
Bear markets and deflation

• A bear market sometimes causes a downward spiral.

• A decline in share prices, leads to reduced equity but the debt remains the same. This forces banks and companies to raise money. This is achieved by selling assets. This causes lenders to curtail lending which results in contraction of credit in the economy, which results in the sale of assets and the vicious cycle continues.
Changing sentiment

When a bull market turns into a bear market:
- greed turns to fear.
- knocks confidence.
- reduced lending and borrowing.
- reducing the velocity of money changing hands.
- causes credit to shrink and can lead to deflation.
Chart courtesy: SuperCharts by Omega Research
Falling Dominoes

- Falling Dominoes in a market meltdown would affect stocks, commodities and bonds.
- There is interconnectedness of high speed trading platforms and computer generated trading that is making falling dominoes increasingly possible.
Implications for individuals

- Individuals can reduce their exposure to the stock market and sell on rallies.
- Put some money in more than one safest banks.
- Keep some cash liquidity.
- Have insurance with the safest firms.
- Avoid debt.
- Plan to buy assets at the bottom of the market.
Implications for business

- Businesses should avoid overextending.
- Reduce debt.
- Plan to buy businesses when the market is at the bottom.
- Governments, financial institutions and other experts opinion should be taken with a pinch of salt.
Rating Agencies

• High graded bonds suddenly get junk rated in a short space of time without any warnings from the rating agencies.

• Rating agencies missed what was going on in Enron, Lehman Brothers and others.

• Enron had “investment grade” status just 4 days before it went bankrupt.
Bond Investment

In anticipation of a deflation, is it safe to invest in bonds?
Mitigating Risks

- Innovations
- Fiscal discipline
- International co-operation
Current situation

The stock markets and the business cycle in big economies are in an upward trend and hence the risk of global deflation is reduced probably for the short term.
Conclusion

- How a deflation could occur.
- stock market cycles and deflation.
- implications for the individuals and businesses.
Disclaimer

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