



# Napa Wealth Management's The Sensible Investor



September 2009

## Deflation—Another Byproduct of the Recession

By George P. McCuen, CFP®, President



You have probably heard more economic terms tossed around during the past year than you have during your entire lifetime— unless economics was your focus in college or part of your job. An economic effect we are dealing with now is called a deflationary economy.

Richard Fisher, president of the Federal Reserve Bank of Dallas, said he sees “deflationary risk” as pre-eminent and that he anticipates businesses will continue to keep a tight rein on spending in the near future, as “markets are still a long way from having normalized.” Let’s take a closer look at the text-book definition of deflation.

In economics, deflation is a decrease in the general price level of goods and services. Deflation occurs when the inflation rate falls below zero percent, resulting in an increase in the real value of money – a negative inflation rate. Deflation is linked to recessions— and indeed the Great Depression— where prices fall in order to attract buyers. Deflation can be good for consumers, but currently we are seeing an increase in household savings. Add to that a tight rein on spending by businesses. Simply stated, the lack of spending by households and businesses is not helping to stimulate economic growth.

You may have heard that there has been a recent increase in consumer spending. But a closer look may show that the “Cash for Clunkers” program that recently ended along with the tax credit for first-time home buyers that will end in November were major catalysts. These programs can pull spending forward, compel people to spend sooner than later at the risk of a subsequent re-weakening of activity. The unemployment rate continues to rise and if the government stops creating incentives, most Americans will not step up to

spend at the frenzied pace of the past.

While getting a hair cut recently I asked my barber how his business was doing. He said it was down although he hasn’t lost any of his clientele. Now how does that work? Unless you are going bald you need regular haircuts and most men won’t let their wives do it. He explained that his clients are waiting longer between cuts. When I asked about the cost of my haircut, assuming there would be a price increase, he said there was no change in the price of his cut. He said he had not increased his prices in three years and recently remodeled his salon to stay up-to-date and attract more customers. “This is not the time to raise prices,” he said. It is interesting to note that his costs over the past few years have increased but he is not able to pass those costs on to his customer. He is working harder to keep business coming in and making less money – a common theme these days. Is he out borrowing and spending? I don’t think so. Now there is an economic indicator if you asked me!

Economies are very slow to recover following severe financial crises. Consumer demand, which accounts for more than half of U.S. economic activity, is expected to remain weak. As companies seek to preserve their bottom line, the result will be a prolonged period of tight budgets and cost-cutting.

Have we hit bottom as many economists, government officials and Wall Street analysts have proclaimed? Or are we in for the dastardly “W” economic recovery where we drop one more time before we recover from this Great Recession? Deflation should give the consumer the upper hand but that is not happening yet. We remain cautious. Next up, inflation (but we are far from that right now).

Stay tuned and keep looking up!

George



# Demand and our Economy

By Jim Riley, CFP®, EA, Senior Financial Advisor

The president of my Rotary Club recently asked me to speak to our members about the outlook for the stock market and the economy. A very straightforward request but there was a bit of a problem – I was allotted 25 minutes. 25 minutes is not much time to talk about the stock market much less the vast U.S. economy. After mulling this over for quite a while I hit upon an idea. I wouldn't go into tax hikes, tax cuts, deficits, trade imbalance, etc, etc, etc. I would concentrate my talk on just one facet of our economy: demand. Why demand? Because if there is one thing that all successful businesses have required since the dawn of time, it's the presence of demand for goods and services, and without successful businesses our economy, in turn, cannot be successful, strong and expanding.

Furthermore, I decided to concentrate on only two understandable and crucial aspects of demand, that being unemployment and the tightening of consumer credit.

Since December of 2007 the American workforce has lost 7 million jobs. According to a Labor Department report released on September 2, 276,000 jobs were lost in July and 216,000 jobs were lost in August. The rate of job loss is slowing, however, and we have not seen unemployment rise as dramatically as it did in the first three months of the year. Good news? Perhaps, but what is needed for demand to begin to increase is job growth not simply a slowing of loss.

Unemployment pulls the economy and markets in a downward spiral. If Factory A lays off 25% of its workforce then that means fewer individuals are purchasing the goods manufactured by Factory B and thus Factory B lays off some of its workforce, and so on. When unemployment is increasing then factories are either closing or operating at reduced capacity. For demand to be high and for the economy to expand we need factories that are expanding their operations. Similarly, the drop in manufacturing

jobs goes hand in hand with a drop in jobs in the service industries.

Consumer credit is also a useful indicator for studying demand. Like unemployment, consumer credit is an enormous topic which can't be discussed in depth in a newsletter article. But we don't need to go into depth on credit issues to make a point – suffice to say that in the first quarter of 2008 U.S. credit card balances rose by \$120.8 billion dollars. In the first quarter of 2009, credit card balances declined by \$90.7 billion – that's a swing to the negative of \$211 billion dollars and thus more downward pressure on demand. That's \$211 billion that is not being spent at the supermarket, mall or the auto dealer and contributes to more and more layoffs and less and less spending. And the credit card figures are small compared to the **2 trillion** dollar decrease in total U.S. borrowing during 2008.

In a September 6 radio interview, Joe Nocera, business columnist for the New York Times, referred to our current economic situation as “the jobless recovery”. He went on to point out, “An improvement in employment and consumer spending is needed for a full recovery, but there's no sign yet of that happening”. Nigel Gault of IHS Global Insight recently stated that “There isn't the underlying fuel there for strong consumer spending growth”.

As our clients know, we have declined to jump on board the bull market bandwagon that is being loudly touted by the financial media. The state of demand in our economy demonstrates the underpinnings of our position. There has been progress towards improvement in the economy, but right now, with issues such as slack demand staring us in the face, we continue to proceed with care concentrating our clients portfolios. Like Joe Nocera, we just don't think the “jobless recovery” is sustainable.

Frankly speaking,

Jim