How to Survive Deflation

by David Stanowski

20 April 2009

Abstract:

Everyone has learned to live and invest in an inflationary environment. Now that the government has ramped up its bailouts and stimulus plans, many are preparing for the hyperinflation that may or may not materialize at some point in the future. What most people fail to recognize is that we're currently experiencing Deflation. Since Deflation could have a long way to go, the failure to adjust to these new conditions could mean financial ruin!

Introduction:

Most people focus only on prices when they try to gage inflation and deflation, but it's not that simple, because prices respond to supply and demand as well as inflation and deflation, so they are only one indicator.

Properly defined, inflation is "increasing money supply and credit, with credit marked-to-the market", and deflation is "decreasing money supply and credit, with credit marked-to-the market".

Using this definition of deflation, it is clear that it began with the top of the housing bubble, and subsequent contraction in mortgage debt and equity withdrawal, in 2005; grew stronger with the top in the stock market, and the more general contraction of bank credit, in 2007; and accelerated with the collapse of the investment banks last year, which forced the liquidation of a lot of the new "securitized" debt instruments.

Regardless of the temporary Bear Market rally in the stock market, credit card debt continues to contract, the commercial real estate market has begun its collapse and credit contraction, unemployment is contracting the workforce and salary reductions are becoming more common, and other bank credit and exotic debt instruments continue to lose value; so more deflation appears to be in our future!

Other signs of deflation include:

Falling yields on Treasury debt, rising yields on corporate debt, the rising value of the Dollar, rising unemployment, negative GDP, acceleration of the base money supply, banks hoarding cash because they are unwilling to lend, the rising savings rate, and the rising number of bank failures.

Which price changes give valid signals?

There is no doubt that price changes can help to determine the presence of

inflation or deflation, but those who look only at prices fail to answer many questions like: do rising prices of gold, oil, food, or other commodities signal inflation? What about rising real estate and stock prices? What if some prices are rising and some are falling? For example, stocks could be falling while gold is rising. Should the CPI or PPI be used to make this determination?

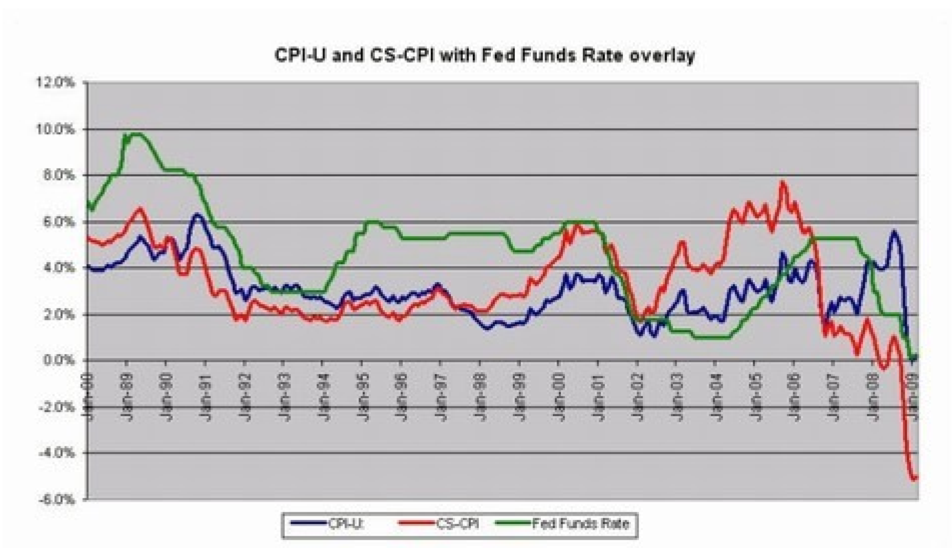
Price data that tends to confirm deflation:

Falling home prices, falling stock prices, falling commodity prices, and the falling CPI and PPI (see below):
The first YoY decline in the CPI since 1955
The biggest drop in the PPI in 59 years

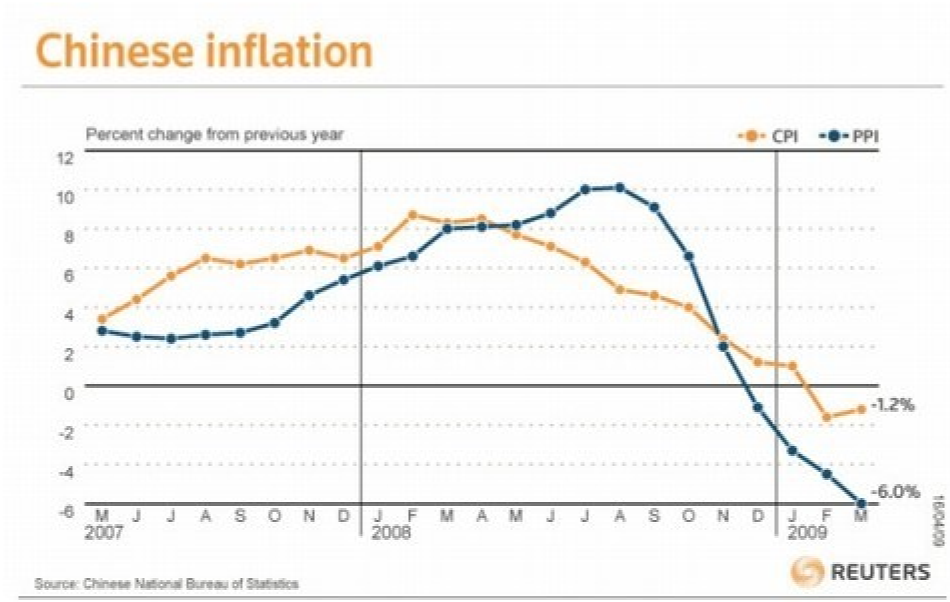
Owners' Equivalent Rent (OER) is the largest component in the government measure of the Consumer Price Index. OER is a process in which the BEA estimates what it would cost if owners were to rent the homes they own from themselves. OER is not a valid pricing barometer.

By ignoring actual housing prices, the CPI massively understated inflation for years, but now it is massively overstating inflation.

The following chart shows the effect if the Case-Shiller housing index is substituted for Owners' Equivalent Rent in the CPI (red line). The Case-Shiller CPI has been negative for the past three months, and currently stands at -5%!



- **Deflation Has Gone Global**
- **Japanese wholesale prices log fastest drop since 2002**
- **German wholesale prices see worst decline in 22 years**



[Fiat World Mathematical Model](#)

What does the change look like?

Joe is a successful businessman and investor in Florida. Over the last 35 years, he has learned how the inflation game works. He owns a very nice house, a rental house, and a beach house that he rents out when he's not using it. He also owns a strip center with 16 small retailers as tenants.

Joe owns a large portfolio of stocks in his 401K, and he bought two new cars, and a nice boat in the last 4 years, using loans from his bank.

Finally, Joe owns one of the most successful bars in town. It is located in a building that he leases for $8,000/month.

During the 2004-2006 real estate bubble peaking process, Joe pulled as much equity out of his three houses as he could, and used the money to do the traveling that he always wanted to do.

What has happened to Joe's profitable strategy between late 2005 and early 2009?

The value of his home and rental houses have declined 45%. The value of his beach house has declined 55% as the vacation-home market has been crushed, and his rental income is down as fewer people can afford to rent it. Joe is trying to sell the beach house before the bank forecloses, but he owes more than it is worth.

Joe has already lost five of his tenants in the strip center, and others are

telling him they may have to leave, if he doesn't lower the rent. This has turned his cash flow negative, and if he can't turn this around, he may lose this property.

His stock portfolio has lost 50% of its value since 2007, and due to his reduced income, he hasn't made a payment on his boat in four months. He's trying to sell it before it is repossessed. In fact, Joe really needs to sell one of his cars, if he can get enough to pay off the loan.

At his bar, Joe used to sell a lot of beer at $4 bottle, but he has seen his sales steadily erode. He knows that people still want to drink, in these hard times, but if he doesn't lower his price, more and more of his customers will drink at home to save money. Many of them have lost their jobs, taken pay cuts, lost their homes, or seen them erode in value dramatically. People are scared, so they have cut way back on their spending.

If Joe doesn't get his sales back up, he is going to have more and more trouble making his lease payment. His plan is to try to negotiate a reduction in his rent, and in the cost of his beer, while he lowers the price on his beer to $2 per bottle. This strategy might work to keep the bar in business.

The paradigm shift.

It has taken some time, but Joe has learned the new paradigm that works during a deflationary period. It is not surprising that it is basically the opposite of what worked for him all those years of inflation.

During a deflation, most assets fall in price dramatically, and nearly all fixed-price long-term financial commitments like mortgages, commercial property loans, and long-term commercial leases work against you, because they do not automatically adjust to an environment of lower incomes and cash flows.

It is much better not to own tangible and financial assets, but if you do, don't use them as collateral against corresponding debt, or they may be lost. During a deflationary period, CASH is KING, and short-term flexible commitments work best. Most people are forced to sell assets, often at very low prices, to raise the cash to make this transition, but it works much better if you get out ahead of it and sell before you are forced to.

Joe will survive this Deflation, if he can shift to this new paradigm before it's too late.

Conclusion:

Switching from an inflationary environment to a deflationary environment

has literally turned the world upside down. Many people have discovered this the hard way, and millions more will soon! It's time to learn all you can about this new world of Deflation.

Click here to download EWT's free "Deflation Survival Guide".

Or Even Better,

Click here and scroll down to get your copy of the best book on Deflation: "Conquer the Crash".

Is Your Money Safe?

For more information on the Economy: CLICK HERE

David Stanowski lives in Galveston, and is a financial analyst, investor, and the publisher of GalvestonEconomicReport.com, TheFinancialHelpCenter.com, and TheRealGalveston.com.