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# Deflation Concerns and the Risks of Policy Mistakes



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The worldwide battle against deflation continues. Whether global policymakers deploy appropriate strategies to offset deflationary pressures will be the most important factor in determining the strength of the financial markets and the ultimate duration of this cycle.

Only a few months ago it seemed that the threat of a prolonged period of widespread deflation had diminished. In the aftermath of the 2008 financial crisis, former U.S. Federal Reserve Chairman Ben Bernanke and his Fed cohorts wrote the playbook on combating deflation. The zero interest-rate policy and massive quantitative easing programs raised inflation expectations, boosted asset prices, and helped rejuvenate credit creation. The European Central Bank (ECB), in the aftermath of its own poor policy choices, and the Bank of Japan (BOJ) followed suit. At last count, 27 of the world's 34 major central banks were either easing monetary policy or were on hold.

## So, What's Changed?

A number of factors have revived deflation concerns:

1. Global growth is actually slowing, rather than accelerating. Forecasted production is falling in most of the world's major economies, with the exception of the Eurozone and India.
2. Chinese policymakers, given the sharp slowdown in Chinese economic activity and concerns about tighter monetary conditions, have allowed market forces to play a bigger role in setting the exchange rate. This will likely lead to the renminbi falling further in the coming months. While directionally appropriate, the People's Bank of China (PBOC) engineered the devaluation poorly and failed to provide appropriate forward guidance to markets.
3. Commodity prices in general, and oil in particular, have fallen steeply amid slowing global growth and a petro-supply overhang.
4. Falling commodity prices continue to drive inflation expectations lower in many commodity-producing countries. Their currencies are weakening against the dollar at the same time global risk aversion increases and the potential for further Chinese currency devaluations looms large.

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5. The Federal Reserve's long path toward normalizing monetary policy has been U.S. dollar positive **Exhibit 1** ▼, which has made the cost of imported goods in the world's largest economy cheaper.

In a deflationary environment, one policy misstep raises the risks to global financial markets considerably. Policy mistakes in a world of excess demand (i.e., holding interest rates too low for too long) can be overcome. Policy mistakes in a world of excess supply and spare capacity (i.e., normalizing a zero interest rate policy too soon) are far more damaging (see the U.S. 1937, Japan 1995). No central bank to date has shown an ability to completely emerge from a deflationary spiral.

In a deflationary world:

- A. Consumers are less willing to spend (why shop if prices will fall further in the future?),
- B. Investors are less willing to invest (0% interest at the bank is fine if inflation is -2%), and
- C. Businesses and households are less willing to borrow (repaying loans in an increasingly strengthening currency is never ideal).

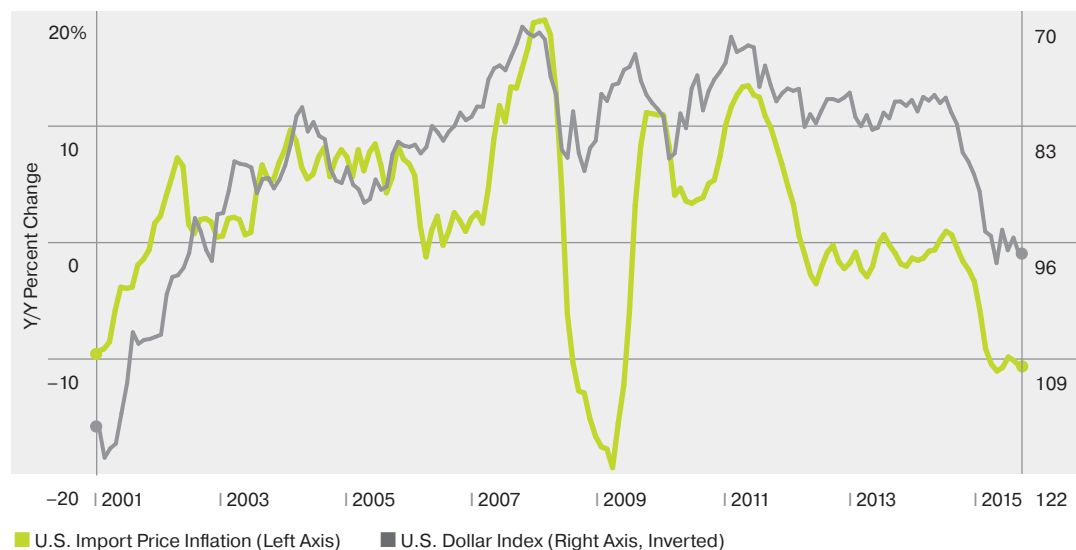
A cycle of falling prices that lead to declining corporate profits that result in lower wages, which then repeats over and over, is indeed vicious. As an investor, I am programmed to think about what might go wrong. All the current talk of deflationary concerns and policy mistakes may be troubling, but no less troubling than it has been since the financial crisis. Yes, it is scary, but no scarier than when the global financial system was breaking down or the European Union appeared ready to disintegrate or oil prices were correcting by 50%.

Decent growth and enlightened policymakers reduce the likelihood of low probability but high risk "tail events." More optimism, and less capitulation to worries about severe tail events, is still today's calling—deflation fears and the potential for policy mistakes notwithstanding.

One of the key things an investor must still do, despite all these concerns, is be in the markets. I continue to believe that weak global growth will cause central banks to maintain easy monetary policy longer, thereby extending the credit cycle (as well as the business and market cycles) far longer than many believe. Recessions, at least in the U.S., have always been preceded by either substantial central bank tightening (1991, 2000) or inflation acceleration or both (1974, 1981). Neither is on the horizon and likely will not be for a very long time.

Exhibit 1

#### U.S. Dollar and U.S. Import Price Inflation



Sources: Bloomberg and Bureau of Labor Statistics, 8/31/15. The U.S. Dollar Index (DXY) indicates the general international value of the U.S. dollar by averaging the exchange rates between the U.S. dollar and major world currencies.

If that base-case outlook is correct, then global equities will continue to outperform bonds and credit. Following this bout of energy-driven weakness, credit will once again outperform Treasuries well into the future. Interest rates, both the short ones set and anchored by global policymakers and the long ones that reflect nominal growth potential, will stay low for a long time.

## Importing Deflation from China

The epicenter for potential policy mistakes is in China. A growing source of deflation to the world, China's weak economy has been a major drag on global activity, hurting not only other emerging markets but also Japan and Europe. For commodity-producing countries, the decades-old export model is over.

Chinese officials have struggled to stimulate and reflate the domestic economy, which is weighed down by severe levels of excess capacity and overinvestment that have built up in recent years. The growth rate in the M2 money supply is declining and the consumer price index continues to fall below the PBOC's perceived comfort zone.

**Exhibit 2** ▼

China's recent modest devaluation of the renminbi was directionally appropriate but tactically a failure. In central banking, expectations and forward guidance matter. Chinese policymakers left investors wondering whether the goal of the more flexible exchange rate was to:

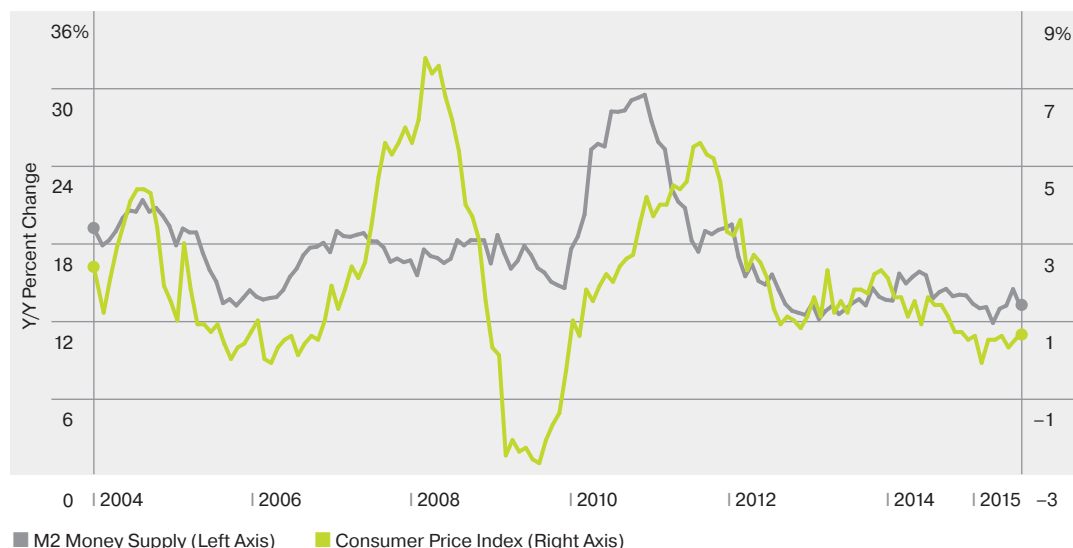
- A.** Gain favor with the International Monetary Fund to support the renminbi's candidacy for reserve currency status,
- B.** Stimulate exports,
- C.** Ease monetary conditions, or
- D.** A combination of all three.

Make no mistake, I believe the primary purpose was to ease monetary conditions in China. And there's the rub: China would have been better served had it taken a page out of ECB President Mario Draghi's or BOJ Governor Haruhiko Kuroda's playbook and signaled a large enough depreciation of the renminbi to raise inflation expectations and attract capital. By surprising the market with the timing of the move and then telling the world that PBOC policymakers won't devalue further, when they actually might, has had the adverse effect of scaring capital out of China and further tightening monetary conditions.

### Exhibit 2

#### Deflationary Pressures In China

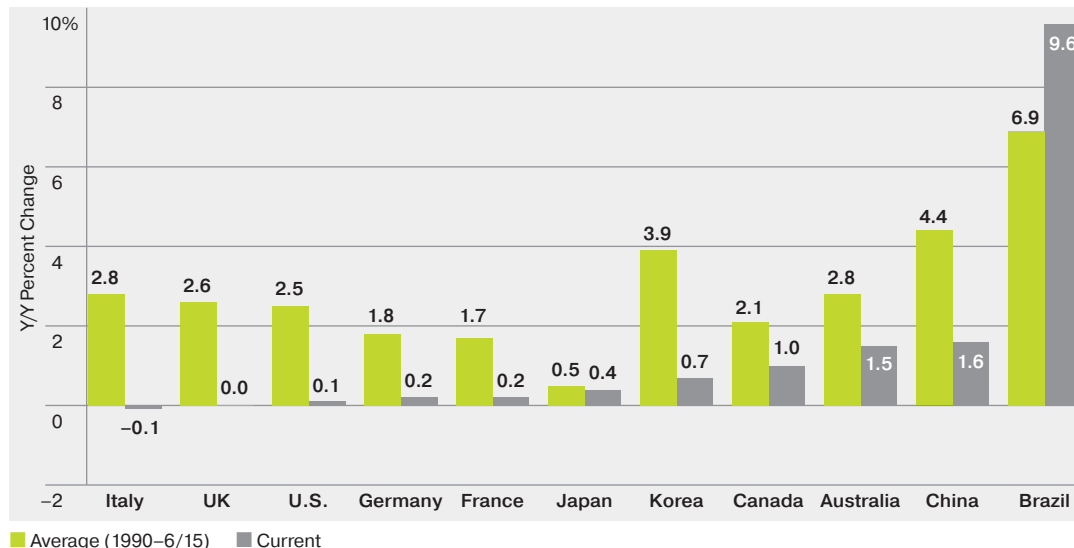
China Consumer Price Index vs. China M2 Money Supply (12-Month Lead)



Sources: Bloomberg, The People's Bank of China, National Bureau of Statistics of China, 7/31/15. M2 Money Supply measures the total amount of money in circulation in a country. 12-Month Lead is displayed to more clearly show the relationship between M2 and inflation by moving M2 forward by 12 months.

## Exhibit 3

## Consumer Price Index by Country



Source: Bloomberg, 7/31/15. Brazil's average is from 1995–6/30/15.

As for the rest of the world, the renminbi's modest devaluation is driving other Asian currencies sharply lower, further weakening the competitive benefit the PBOC may have been seeking. The Turkish lira, Mexican peso and South African rand have touched record lows versus the dollar, while the Malaysian ringgit and Indonesian rupiah have fallen to their lowest levels since the 1998 Asian currency crisis. Devaluations are depressing the prices of global goods and importing another round of deflationary forces into the developed world.

In theory that might sound like a good thing for the U.S. consumer, but a stronger dollar is a headwind to U.S. exports, corporate profitability and, ultimately, wages. As for the import side of the equation, if U.S. consumers believe that the price of goods at Walmart will be lower next weekend than this weekend, they will put off making purchases and economic activity will grind lower.

A weaker renminbi might give a modest push to the Chinese economy, but it is inadvertently tightening monetary conditions and may lead to an even more pronounced slowdown than prior to the devaluation. That is supportive of U.S. dollar strength and will keep U.S. interest rates low even longer. If the bull market ends prematurely—and that is still not my call at the moment—it will be because China's policymakers worsened Chinese economic conditions through their misguided moves.

### The Fed's Policy Challenges

The policy challenge is especially acute for the Federal Reserve. Tighter policy strengthens the dollar and effectively chokes off the current growth spurt in the U.S., the low unemployment rate notwithstanding. This point likely isn't lost on Fed Chair Janet Yellen, New York Fed President and Federal Open Market Committee (FOMC) Vice Chair William Dudley, and the rest of the FOMC's policy doves.

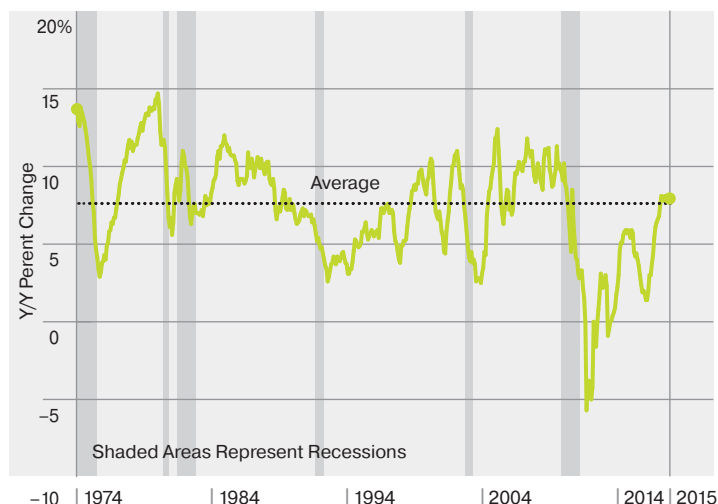
From a cyclical standpoint, it appears that the U.S. economy is accelerating and thus immune to global pressure. But there is no doubt in my mind that even the U.S. economy, the best-adjusted of the world's economies since the financial crisis, will also slow. The strong dollar and ensuing flow of capital out of the weakening growth countries and into the U.S. will weigh on exports.

A strong currency environment typically is favorable for a consumer-based economy, as pickups in consumption and investment more than offset the drag from the export sector. But this is not a typical environment. The combination of weak wage growth and a lack of significant household re-leveraging in the U.S. will prevent those upticks in consumption and investment from taking place. What's worse is that the headwind to profits for U.S. multinational companies will actually cause investments and consumption to weaken alongside net exports.

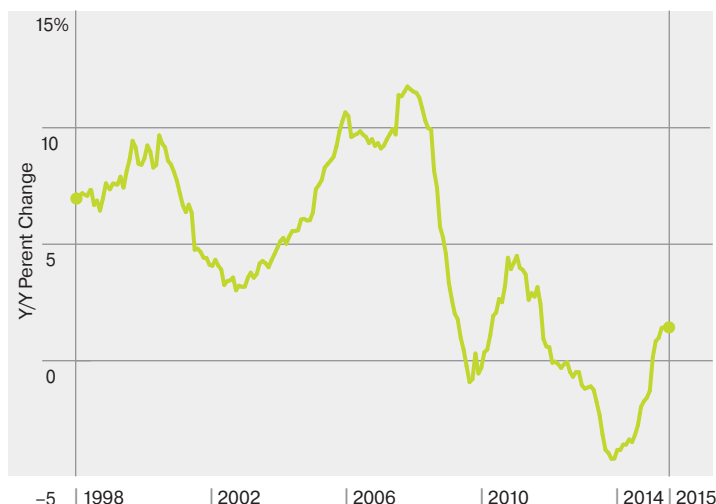
#### Exhibit 4

### The Credit Cycle Is Still Young

#### U.S. Bank Credit Growth



#### Euro Area Bank Loans to Residents



Sources: St. Louis Fed, European Central Bank, and Haver Analytics, 6/30/15.

The Fed's desire to normalize policy is more about symbolism than anything else. It's about turning the page on the financial crisis and signaling that the world's largest economy can raise interest rates and the sun will still come up the next morning. I won't argue that truth but it still doesn't mean the timing is right.

Consider the Fed's price stability mandate. The mere mention of the topic sends investors harkening back to the stagflation era of the 1970s. But today price stability in policy parlance means something completely different. Let's look at the facts:

- The U.S. personal consumption expenditures index, the Fed's preferred measure of inflation, has not been above what is widely perceived to be the Fed's 2% target in more than three years.
- U.S. import price inflation has fallen by 10% over the past year.
- The annual percent change in the consumer price indices of all of the world's major economies (except Brazil) is currently well below their long-term averages. **Exhibit 3** ◀

William McChesney Martin, the longest serving Fed Chairman in history, once famously quipped, "The Federal Reserve...is in the position of the chaperone who has ordered the punch bowl removed just when the party was really warming up." If the Fed is indeed the chaperone of the U.S. economy, then instead of removing the punch bowl the Fed should consider making the punch bowl's contents more potent.

### Whither Asset Bubbles?

One question is how to square the Fed's battle against deflation with investors' fears of inflating asset bubbles. The former is part of the Fed's mandate, the latter is not. Fed Chair Yellen is already on record saying that the goal of central banks is not to prevent asset bubbles from occurring but rather to make sure the financial system is resilient should bubbles occur. Are we now sowing the seeds of the next 2000 tech wreck or 2008 housing crisis? No, not from where I sit.

For all the hand wringing over asset bubbles and central banks erring on the side of being too accommodative for too long, there are few signs of excess:

- **Credit growth is not outsized** I don't believe there's an asset bubble, but even if one existed, it is accelerating credit growth that feeds the bubble that really matters. U.S. bank credit growth is now climbing more than 8% year over year, which is back in line with the long-term average yet still below the prolonged periods of 10%-15% credit growth that often presage the end of business cycles and notable increases in defaults. What's more, in Europe, private-sector loan growth recently turned positive for the first time since 2012. **Exhibit 4** ▶

- Bond yields are reflective of a weak growth world** Select investors and certain bond market heavyweights have, at different times, identified fixed income assets such as U.S. Treasuries, German bunds, and high yield corporate bonds as being dangerously close to bubble territory. I vehemently disagree. In a country that posted second-quarter 2015 economic growth of 2.3% on a quarter-by-quarter annualized basis, and headline inflation of 0.1% over the last year, 10-Year U.S. Treasury rates in a trading range of 2.0% to 2.5% are entirely appropriate. High yield bonds trade at an even more reasonable spread to benchmark rates than they did at the start of 2015. Defaults are likely to stay low as debt coverage ratios remain sound and the market faces few bond maturities between now and 2017. Recent underperformance can be attributed almost entirely to the energy sector. **Exhibit 5 ▼**

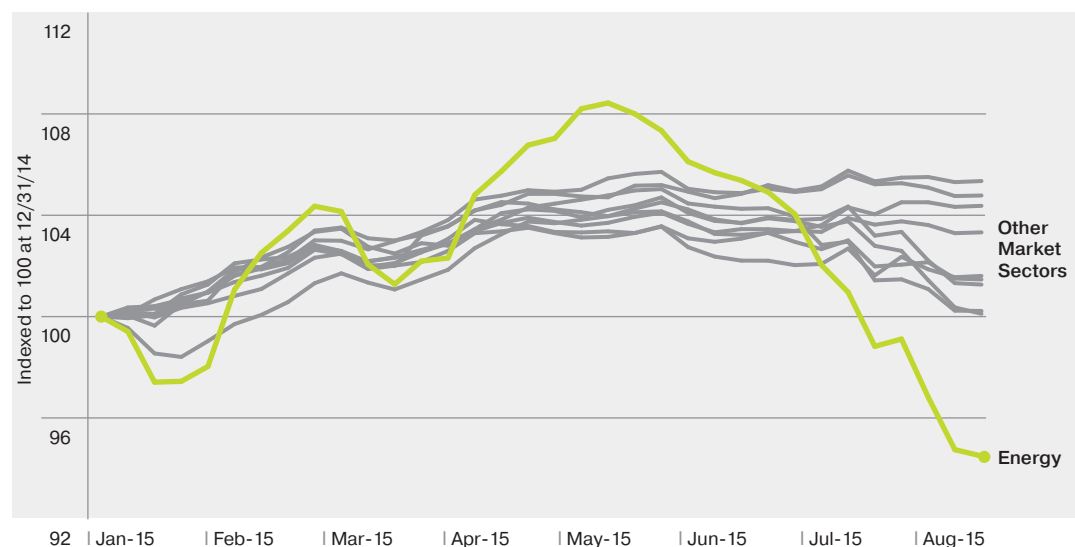
Furthermore, I believe that supposed liquidity concerns in the bond market are a myth created by Wall Street in hopes of repealing regulation. Spreads will of course widen in the event of a bond market sell-off, but there is enough appetite for yield that more than enough investors will be available in the marketplace to provide the other side of the trade.

- Equity valuations are relatively attractive** Global equity valuations are generally in line with or slightly above long-term averages and attractive when low interest rates, low inflation and the benign monetary policy environment are factored into the calculation. Emerging market equities are now trading below long-term averages.

#### Exhibit 5

##### High Yield Sector Indices

Bloomberg High Yield Sector Indices Year-to-Date Weekly Cumulative Returns (Based at 100)



Source: Bloomberg, 8/17/15. The Bloomberg USD High Yield Corporate Bond Index is a rules-based, market-value weighted index engineered to measure publicly issued non-investment grade USD fixed rate, taxable corporate bonds. The 10 sectors shown above are all part of the Bloomberg USD High Yield Corporate Bond Index and include energy, industrials, materials, financials, communications, utilities, technology, consumer discretionary, consumer staples, and healthcare. **Past performance does not guarantee future results.**

### Conclusion

For long-term investors, the most important things are to get the big calls right and ignore the noise. What are those big calls?

1. We are in a slow-growth world with little inflation in sight. In fact, deflation is the far bigger threat. The risks global central banks face from not tightening policy are small. The risks of tightening too soon are huge.
2. Global policymakers will remain accommodative well into the future. The Fed's first rate hike since June 2006, whenever it comes, will likely be the last for a while. It may be one-and-done, just like in 1996.
3. The usual indicators of the end of a cycle are nowhere in sight. By my assessment, the credit cycle, which is a harbinger of future economic activity, is just getting started. Ultimately, this credit cycle will be the longest on record.

In the current environment, I continue to favor global equities over bonds and credit over Treasuries. Benchmark returns will be more muted than in the past six-and-a-half years and bouts of volatility will occur as they do in any bull market. However, in a world where growth is scarce, investors will continue to pay up for it, wherever they may find it. Fortunately, there is no shortage of growth trends, and some individual companies and sectors are growing far faster than the aggregate global economy.

This has been my call for six-plus years and will likely be so well into the future, assuming that policymakers don't take away the punch bowl at the exact worst time.

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The S&P 500 Index is a market capitalization weighted index of the 500 largest domestic U.S. stocks.

The Barclays Aggregate Bond Index is an index of U.S. Government and corporate bonds that includes reinvestment of dividends.

The Bloomberg USD High Yield Corporate Bond Index is a rules-based, market-value weighted index engineered to measure publicly issued non-investment grade USD fixed rate, taxable corporate bonds. The 10 sectors include energy, industrials, materials, financials, communications, utilities, technology, consumer discretionary, consumer staples and healthcare.

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