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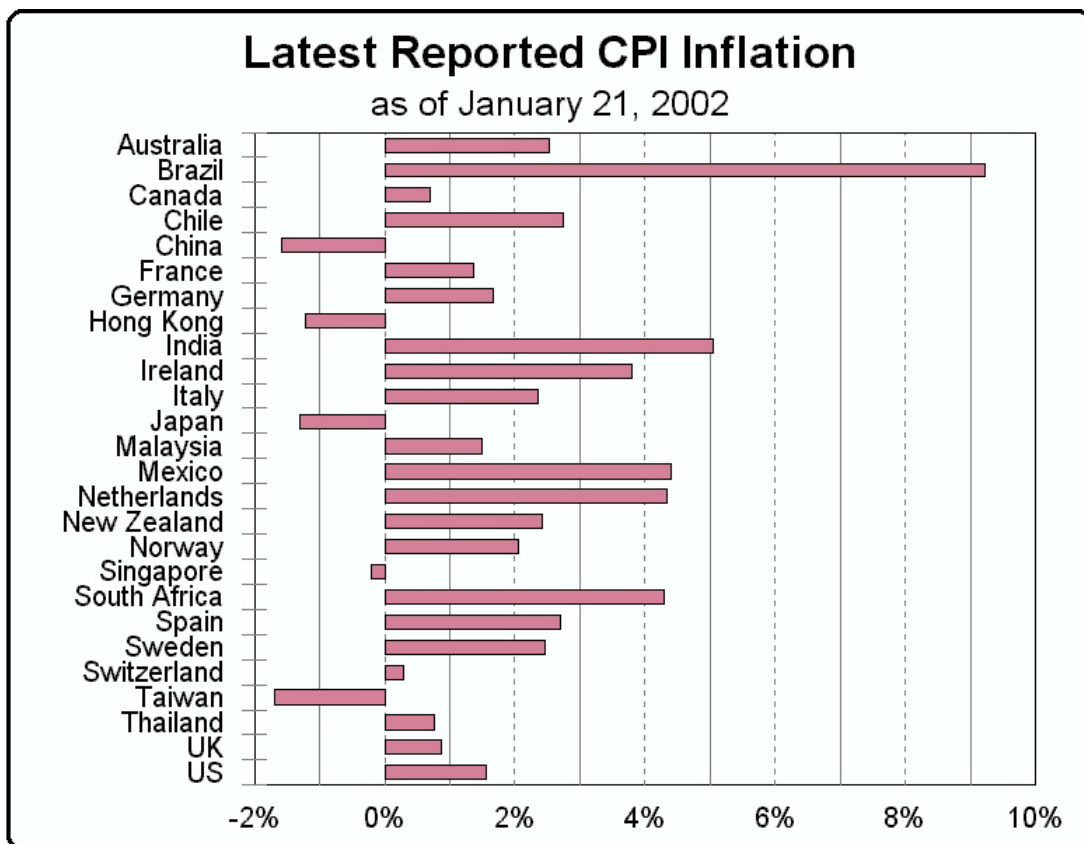
217 East Road
Alford, Massachusetts 01266 USA
telephone 1-413-528-8098
e-mail special@alfordinc.com

Independent Research Providers to the
Professional Investment Community

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Special Report

Deflation Watch Three Countries Join the Annual List Others Have Experienced Short-term Deflation



Five Asian Nations Have Experienced Deflation Over the Past Year

As can be seen from the bar chart on this page, five countries (all in Asia) have experienced negative inflation (deflation) for the most recently-reported yearly span. We expect this pattern to continue and to perhaps even become more pronounced. We also expect that the currencies of Japan, Singapore, and Taiwan will continue to

depreciate over the coming months.

The currencies of China and Hong Kong are pegged to the US dollar, and we suspect there will be no change in those pegs anytime soon. If the Chinese threatened to devalue their yuan (also known as the renminbi), that threat would be taken seriously by other governments in the region and would probably create much consternation. The trouble is, neighboring governments may not be able to do very much in response to avoid Chinese action. We consider the prospect of an actual devaluation of the renminbi to be a remote one, but if it were to occur, it would certainly upset the apple cart in Asia.

The Japanese authorities have been accused by some observers of adopting a “weak yen” policy, but the truth is that they probably couldn’t have prevented the yen from sliding even if they had wanted to. We see further declines ahead for the yen, and anticipate that the dollar/yen exchange rate will reach ¥150 by the end of this year. Bond yields in Japan are the lowest of any major market in the world, and the Japanese equity market doesn’t look all that appealing either, with the economy now mired in what promises to be a long recession. If China or Hong Kong were to devalue their currencies, that would probably only trigger more weakness in the yen, with no net competitive advantage to either country. Therefore, in order to remain competitive and to stimulate demand for their goods and services, both Hong Kong and China (like Japan, Singapore, and Taiwan) will probably have to see their prices continue to decline. Thus, all of Asia looks to us to be poised for (at least) another year of deflation.

Five Other Countries Have Experienced Deflation Over the Past Quarter

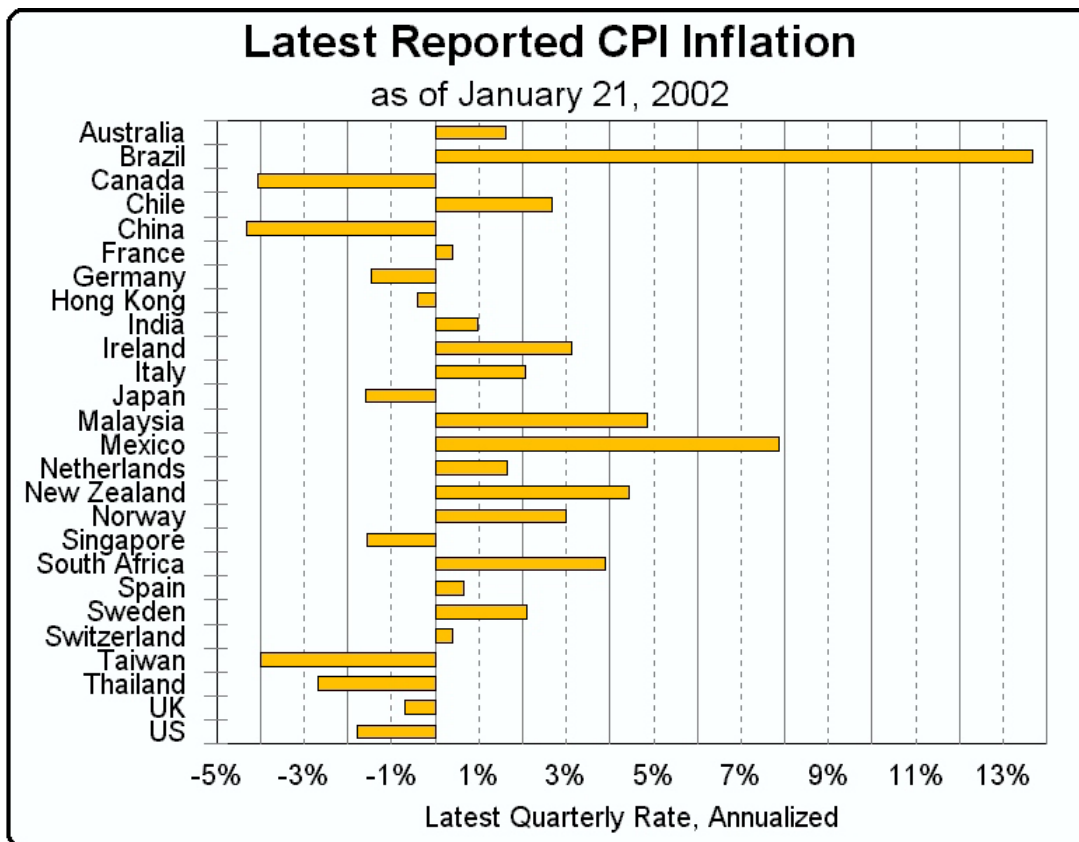
But that isn’t the end of the current deflation story, let alone the deflation outlook. Several other countries have been experiencing deflation lately, if the period measured is less than a full year. The bar chart on the next page reveals that, over the past quarter, five countries in addition to the ones already mentioned have been experiencing deflation.

Specifically, Canada, Germany, Thailand, Great Britain, and the United States have all seen consumer prices decline over the last three-month span for which price indexes have been reported in each country. Please note that on the bar chart, the rates of change are annualized rates, based on the change in the CPI in each country over the most-recently reported quarter.

In Fact, the Majority of Countries Have Experienced Deflation Recently

Additionally, another eight countries are experiencing deflation right now when the measurement period is carefully chosen. In other words, the latest reported Consumer Price Index is lower than it was at some point within the past year. This observation applies to Chile, France, Ireland, the Netherlands, Norway, Spain, Sweden, and Switzerland. Thus, 18 out of the 26 countries shown on our charts are currently experiencing deflation in consumer prices compared with some point over the past 12 months.

This is an extraordinary development, yet one that is hardly mentioned at all in the financial press.



What Has This To Do, As They Say, With the Price of Tea in China?

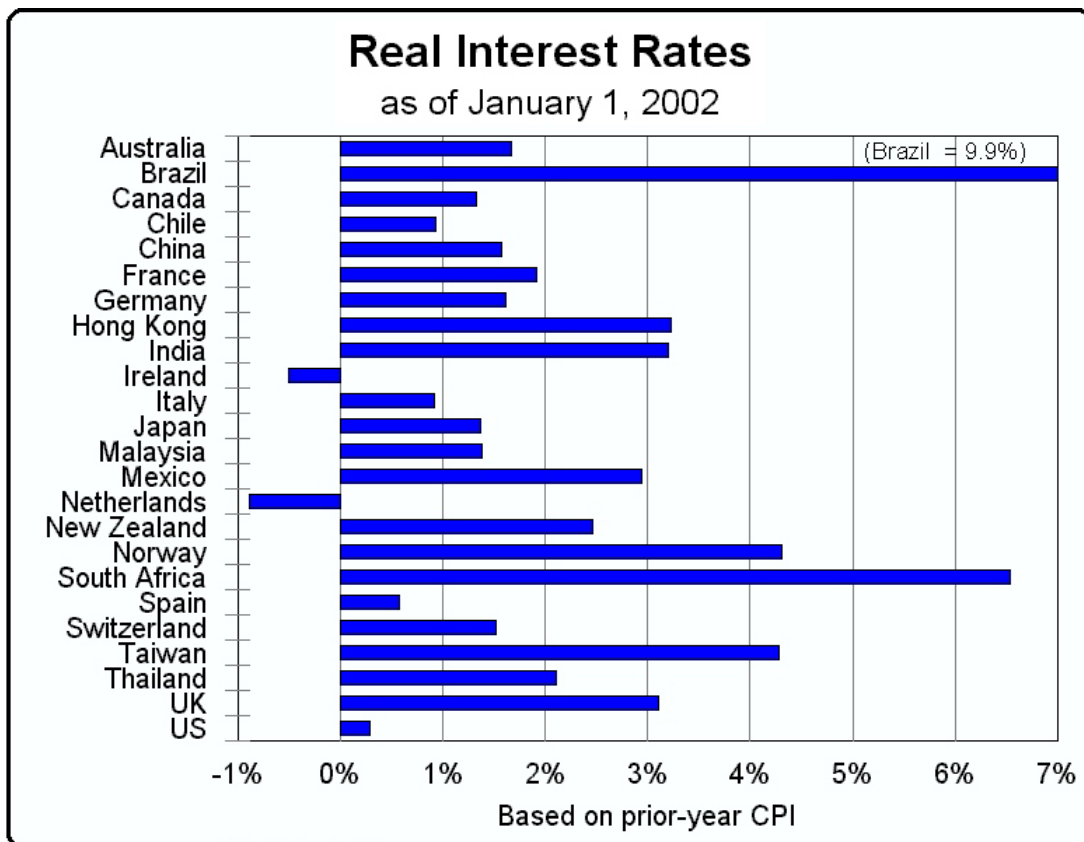
Our hunch is that the globe will continue to be in a deflationary mode for several months, if not longer. What impact, if this comes to pass, will such a development have on FX and capital markets?

First, let us disclaim any belief that deflation, in and of itself, is evil. Deflation, to be sure, has different redistributive effects from those brought about by inflation. It is likely that people with fixed incomes will be beneficiaries, for example, as their purchasing power increases in real terms, and that owners of wealth will be losers as their income declines.

Like inflation, however, if deflation is widely anticipated, it will probably have little or no impact on real economic activity or on capital market returns. To the extent that (the degree of) either inflation or deflation is unanticipated, it may, in the event, have disruptive effects on the economy and the markets. In the present instance, our concern is that investors have not anticipated the switch that has occurred from inflation to deflation, and have not recognized that deflation is going to be with us for some time to come.

Compare our two inflation charts. In almost every country, inflation is lower in the second chart. What this means is that if recent inflation trends continue, realized real rates of return may be higher than what investors are expecting. The flip side of this is that real interest rates may be higher than central banks desire, and even lower levels of nominal rates may be required to stimulate a given level of economic activity.

For equity investors, nominal earnings growth is likely to be disappointing even if economic activity returns to a normal growth path.



Real Interest Rates Are Probably Overstated

Nominal interest rates around the globe have been steadily falling in recent months, but real rates are starting to rise. For any level at which nominal rates are pegged, lower inflation (or higher deflation) leads to a higher real rate of return.

Real rates in the US, for example, had become slightly negative just a couple of months ago, but are now creeping back above zero.

The bar chart on this page uses the latest 12-month CPI inflation number in each country to compute forward-looking real returns based on currently prevailing 90-day interest rates. This calculation assumes, of course, that inflation results will be the same this year as they were last year, and we have been arguing the case that inflation will be lower.

If our hunch is correct that deflation (or, at the very least, disinflation) is here to stay for a few months or even quarters, realized real returns will be higher than indicated on this chart. While this may be good news for fixed-income investors, it will not necessarily be good news for economic activity, and this may take a bit of the wind out of the sails of equity investors, who have been hoping for a revival of the global economy. Equity valuations may also, to some extent, reflect an overly pessimistic view of the potential returns available in the debt markets.

This report was prepared by

Michael F. Wilcox, CFA

michael.wilcox@alfordinc.com