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The Deflation Investor's Checklist

Wednesday, November 21, 2001

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This commentary first appeared on SmartMoney.com on November 21, 2001

Last week I wrote that iconoclastic economists have been warning of deflation for almost five years, based on subtle signs that **Alan Greenspan** hasn't been supplying enough liquidity to meet the needs of the U.S. economy. And now — finally — these warnings have come true in the form of declines in the consumer price index, the producer price index and several other widely followed measures of prices. So suddenly *everyone's* talking about deflation — and not just the iconoclasts.

Deflation isn't kind to stocks. For openers, deflation introduces complex distortions into the economy that make it harder for businesses to do business, and that's bad for all stocks. But more to the point, when the price of everything goes down, corporate earnings have to go down, too. And that means that stock prices will follow.

Think about it. Say Acme Widget sells a million widgets at $100 each, and it costs them $50 to make them — so their net earnings will be $50 million. Now let's say that prices fall across the whole economy by 10%, including the price of widgets — and the prices of all the things that Acme has to buy to make them. That means they'll only get $90 for each widget, but their costs will only be $45 each. If they still sell a million of them, net earnings will fall from $50 million to $45 million. All else equal, with earnings down 10%, Acme's stock will drop 10%. Probably more, because in a deflation all else will *not* be equal, and Acme will probably have a hard time selling a million widgets.

Some version of this effect of deflation should be expected to hit just about every company. So if you're strongly convinced of a deflationary future, and you have the flexibility to get out of stocks altogether, you might want to do just that.

But if you aren't sure whether deflation will really continue, or if you're a portfolio manager whose mandate requires you to invest in stocks — then you should at least hedge a little. You should at least understand which stocks are likely to be hurt the most, and which are likely to be hurt the least, in a continuing deflation — and position your stock portfolio accordingly.

The secret to stock picking in a deflation is simple: The winning companies are those whose products' prices will decline the least — but whose production costs will decline the most. If costs decline more than selling prices, these companies could actually increase their earnings in a deflation. The losing companies are those whose products' prices will decline the most, and whose costs will decline the least. If costs decline less than selling prices, the earnings of these companies will fall even faster than the general deflation of prices in the economy.

That's easy to say, but the dynamics of it are more complex than you might think. To see how they work, let's take a look at two widely held companies, **Microsoft** and **General Motors**. Microsoft is a perfect example of a deflation winner, and General Motors is the perfect example of a deflation loser.

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Let's start by looking at the differences between Microsoft's and GM's ability to keep their products' pricing afloat against the undertow of deflation.

GM is in a terrible position because its products are commodities, interchangeable with the virtually identical products of competitors from around the world. In a deflation — when the **Federal Reserve** creates too little money for the needs of the economy — commodity prices are always hit first and hit hardest because they are universal and liquid, and people can easily exchange them for the money there is too little of.

But Microsoft is in a great position, because its products are unique — why, some people would even say they are *too* unique. There's no commodity substitute for Windows or Office. So Microsoft can hold the line of pricing long after GM has had to throw in the towel. In fact GM has been throwing in a lot more than the towel lately — it's been throwing in free financing and all the trimmings. Call it a promotion to kick-start sluggish demand if it makes you feel better, but that's deflation playing out right under your nose.

Now how about the cost side?

On the one hand, GM derives advantage from the falling costs of the commodity materials that go into its manufactured products. But on the other hand, it's stymied by its enormous labor costs — and the fact that a large fraction of its work force is unionized. That means workers are covered by long-term contracts that guarantee rising wages for many years into the future, deflation or no deflation.

What's worse, GM is cursed by hidden labor costs that extend beyond salaries. The auto maker is on the hook for pension and postretirement health-care benefits for as long as its employees live, with the amount of the benefits keyed to salary levels. The cost of these benefits isn't going to go down with deflation — but the securities portfolios that are invested today to pay those costs in the future will. Historically GM has had difficulty getting even its retirement commitments fully funded — now, if there's a protracted spell of deflation, it could spell disaster.

Microsoft, by contrast, has a flexible labor force and no pension issues. It's true that Microsoft won't enjoy the benefits of falling commodity prices, because commodities aren't an input to its products. But at the same time, its nonunionized labor force is more flexible in terms of negotiating wages, and more accustomed to receiving significant fractions of its compensation in the form of contingent incentives such as stock options.

And Microsoft doesn't have to worry about pension benefits. Its retirement benefits are provided by a 401(k) plan to which the company and its employees make contributions during the employee's working life, and the benefits in retirement are strictly a function of the performance of the investments chosen by the employee. Microsoft is totally off the pension hook.

But there's one other major factor that works in Microsoft's favor in a deflation, and it could be a deathblow to General Motors: *debt*. Microsoft doesn't have any, while GM has a GMC truckload — $144 billion worth, on which it pays interest of $9.4 billion a year.

In an ocean of deflation, that kind of debt is a boulder chained to GM's neck. Because auto prices are going to fall, and some of GM's costs may fall. But that $9.4 billion won't. As deflation marches on, that constant $9.4 billion payment in nominal dollars represents more and more in terms of real — that is, deflation-adjusted — purchasing power that GM must expend to pay for assets that will become worth less and less.

Meanwhile, Microsoft not only has no debt, but it also sits on a mountain of cash — $36 billion, to be exact. And in a deflation that's the opposite of debt. That cash will just get more and more valuable every year, allowing Microsoft to have its pick from among a world of deflated assets any time it wants, and insulating it from the need to take on debt in a deflationary world of too little money in circulation.

GM has $9.5 billion in cash, and in their otherwise dire circumstances that's a very comforting thing. But bear in mind, they will need it. As deflation marches on and GM's revenues fall while its debt-service needs remain constant, it will automatically become increasingly leveraged — so GM will find further debt financing increasingly difficult and expensive.

I'm using Microsoft and GM here simply as examples of general principles. Obviously there are many company-specific factors that must be considered in addition to the effects of deflation. That said, these general principles can easily be applied to other companies. So here's your deflation-investing checklist:

- Buy companies with unique, proprietary products; avoid companies with commodity products.
- Buy companies with small, flexible labor forces; avoid companies with large, unionized labor forces.
- Buy companies with exclusively 401(k) retirement plans; avoid companies with defined-benefit pension plans.
- Buy companies with little or no debt; avoid companies with lots of debt.
- Buy companies with lots of cash; avoid companies that are short on cash.

Remember, deflation is going to be tough on *all* stocks. But if you follow this checklist, at least you'll avoid the worst of the damage. And you might even find a real winner. Because when you think about it, this checklist makes good sense whether or not you see deflation in our future. TM