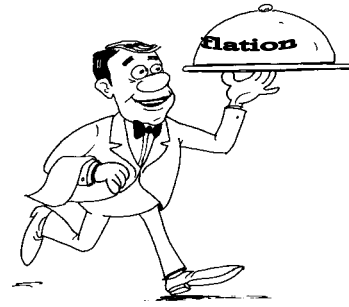


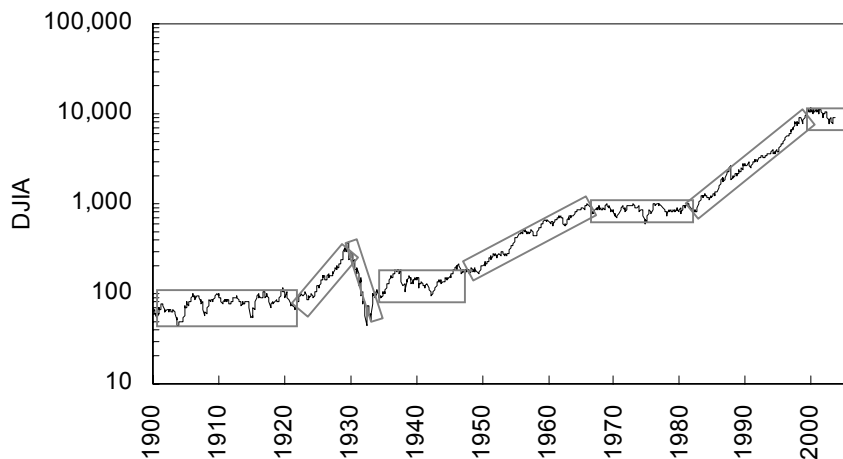
Will That Be Inflation or Deflation?

Economists and market strategists are engaged in heated debates about the future direction of inflation. Some talk about the looming deflation while others claim that inflation is just around the corner -all with convincing reasons. Depending on which side of the fence you stand, you will make decisions about the types of fixed income to include in your client's portfolios. These may involve buying longer or shorter-term bonds or even inflation-indexed bonds. If you are on the right side of the fence, then your clients may benefit handsomely. Otherwise, your relationship with your client may suffer.



Economic activities occur generally in cycles. Since equity market movements are intertwined with economic cycles, let's observe the history of inflation from the vantage point of equity market cycles.

The markets are made of large building blocks that are commonly known as "megatrends" or "secular trends". These are the long-term market trends that can last up to 20 years. Each secular trend consists of several market cycles, which are commonly known as the "bull" and "bear" markets. If the peak of a cyclical bull market is higher than the peak of the previous bull market, then we call it a *secular bull* market. If the low of the cyclical bear market is lower than the low of the previous bear market, then we have a *secular bear* market. If the highs and the lows of the market are at about the same level as in the previous market cycles, then we have a *secular sideways* market. The chart below shows the market history since 1900 using the Dow Jones Industrial Average (DJIA). I placed each secular market trend into a "box" to distinguish the cyclical trends from the secular trends.



Between 1900 and 1921, equities traded in a secular sideways market, trying to break through the resistance level of 100 about six times during these 22 years. In August 1921, DJIA bottomed out at about 67. This was the beginning of the first secular bull market of the century and it moved up until August 1929. This was followed by a secular bear market between 1929 and mid-1932. Between 1936 and 1948, a sideways market prevailed. In 1949, the second secular bull market of the century started. It ended at the end of 1965. Between 1966 and June of 1982, the markets

were stuck in a secular sideways range. The final secular bull market of the last century started in June 1982 and lasted until the end of 1999, when DJIA peaked at 11,497.

Each of the secular bull markets was followed either by a secular bear or a secular sideways market. After the last secular bull market that ended in 1999, it appears that we have avoided a "great depression" type of a bear market. If history is our guide, we can expect this secular sideways market to continue for several more years.

Let's go back to our first question about inflation. The common wisdom is that inflation generally increases as economic activity peaks, generally towards the end of bull markets. When I worked out the historic numbers, I arrived at a different picture: While it is true that inflation may trend higher as a *cyclical* bull market matures, it remains low in a *secular* bull market. While we can expect higher inflation as economy heats up within a cyclical trend, this phenomenon plays differently in a secular trend.

I calculated the average of the market growth and inflation in each secular market (i.e. each "box"). The following table shows the outcome:

Time Period	Mega Trend Type	Average Annual DJIA Growth	Average Annual Inflation
1900 - 1921	Secular Sideways	4.2%	4.3%
1921 - 1929	Secular Bull	16.4%	-1.2%
1929 - 1932	Secular Bear	-31.7%	-6.3%
1933 - 1936	Cyclical Bull	33.6%	1.7%
1936 - 1948	Secular Sideways	3.2%	4.5%
1949 - 1965	Secular Bull	11.5%	1.7%
1966 - 1982	Secular Sideways	1.9%	6.9%
1982 - 1999	Secular Bull	15.9%	3.3%

Next, I took the average of these numbers based on the type of the megatrend:

Mega Trend Type	Average Annual DJIA Growth	Average Annual Inflation	Average Length years
Secular Sideways	3.2%	5.2%	16
Secular Bull	14.3%	1.8%	14
Secular Bear	-31.7%	-6.3%	3
All markets since 1900	7.2%	3.3%	

In secular bull markets, the average inflation was 1.8%. The average growth of equities was 14.3% which handily beats the inflation.

In extended sideways markets, the average inflation was 5.2%, much higher than in secular bull markets. The average growth in equities was only 3.2%. The growth in equities was far short of inflation.

I was not surprised to see that the sharp decline in the equity markets was accompanied by a negative inflation (deflation) in the 1929-1933 secular bear market. The average inflation was minus 6.3% while equity markets lost 31.7% annually during this time period.

I believe the reason for this phenomenon is human psychology. When times are good, as in a secular bull market, people are satisfied with the growth of their assets. In a secular sideways market, people are unhappy with the growth. After a few years of disappointments, they instead demand a higher price for their goods and services. This creates a higher inflation. Obviously in secular bear markets, neither option is available; therefore, both assets and cash flow shrink – loss of assets as well as deflation.

From this historic perspective, assuming that we are in a secular sideways market and we do not slide into a mega-bear market, I have no choice but to believe that higher inflation will prevail in coming years. So, my fixed income portfolio includes a healthy dose of real return bonds and some short-term bonds. I avoid mid- or long-term bonds. We will all see how this plays out.

Bio:

Jim C. Otar, CFP, CMT, B.A.Sc., M. Eng., is a certified financial planner, financial writer, market technician and a professional engineer. Most recently he authored the book "High Expectations & False Dreams – One Hundred Years of Stock Market History Applied to Retirement Planning". His work has been published in various magazines in Canada, U.S. and Australia. His article series in retirement planning won him the prestigious CFP-Board Award for 2001 and in 2002, the first Canadian to win such a prestigious award.