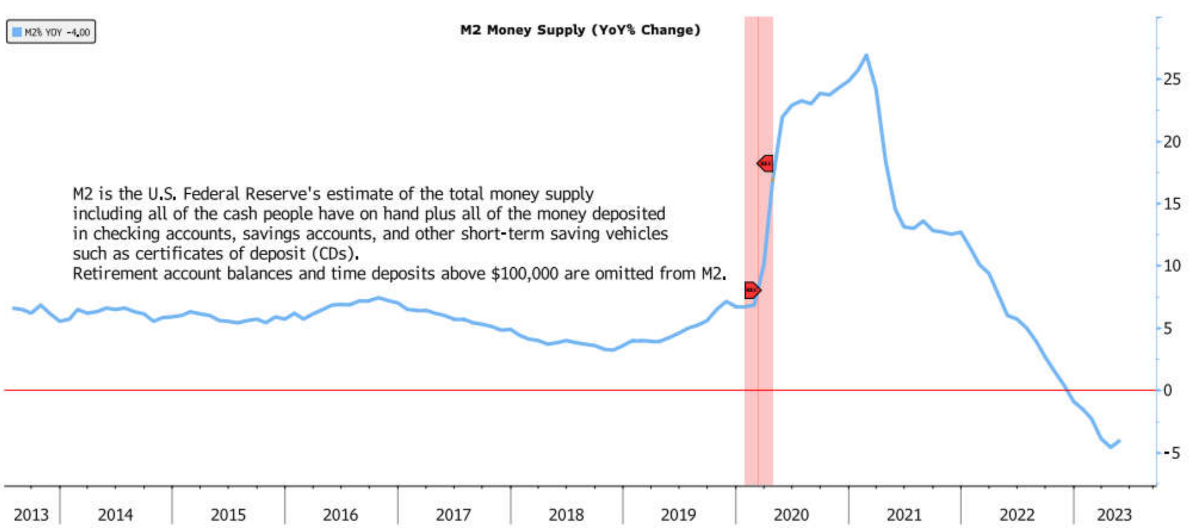
Deflation usually occurs during a recession. As layoffs begin, demand starts dropping. Japans' "Lost Decade" from 1990 to 2001 is perhaps the most well-known example of how deflation can decimate an economy.

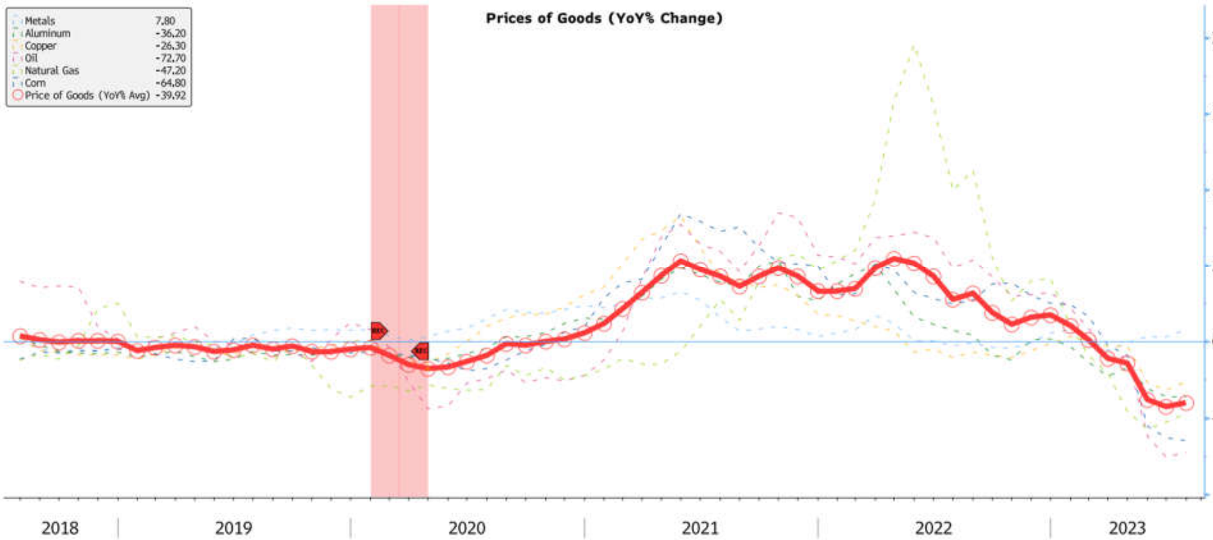
10-months ago, CPI (Consumer Price Index) was at 9.1% on a year-over-year basis, and now it is at 4.0%. We are observing disinflation, which is good considering where we were 10 months ago. The chart below shows the significant decrease in inflation in those short months.

The record increase in the money supply caused by $6 trillion in pandemic relief payments in 2020 and 2021 explains the unleased inflation and the disinflation.

The Federal Reserve cannot take credit for the reduction in inflation, but they are from the sharp slowing in the money supply growth below.



Unemployment and consumer fear are the two biggest factors leading to deflation. Moreover, both could remain high even after companies return to producing at full capacity. The problem with deflation is that prices can keep falling. Rather than chasing lower prices, looking at investments that maintain their value or do not drop as fast may be better.



In the chart above, the price of goods are coming down; Steel, Aluminum, Copper, Oil, and Corn are all down (39%) on average from last year's highs. However, wages are not coming down. Companies will face shrinking margins from higher wages, and slowing growth will compress margins.

On the manufacturing front, we have observed a falling Institute for Supply Management Index, or PMI for short. When this index increases above 50, it implies that manufacturing businesses are continuing to expand. This index fell below 50 in October 2022. In June 2023, the index was at 46.0.

This year, the stock and bond markets have been positive, as evidenced by AI-related companies, while broad US bonds are up 1.5% over the same period. With the possibility of deflation, we have a few thoughts about managing portfolios through a slow-down in growth.

What can investors do?

- Pay down debt/build cash reserves; cash is king.
- Hold some liquid assets like T-Bills and CDs
- Buy Long-Term Bonds. Investment grade bonds, high grade corporate and government bonds
- Add to defensive stocks that sell products or services people cannot cut out of their lives. Think toilet paper, food, health care, and electricity.
- Dividend-paying stocks remain in demand during a recession because of their income. Focus on high-quality dividend-paying companies. Seek companies with pristine balance sheets. Sell highly leveraged companies as underlying companies will see lower margins and losses.—short leverage.
- Invest throughout the downturn; investors will be better positioned when shares rebound.

The S&P 500 continues to move higher, and bond yields beyond two years are lower (prices higher) since the start of the year. Investors are looking past near-term challenges. On the horizon, we see the end of the Fed's rate hiking cycle, stabilization, and reduction of inflation. The remaining question is whether the economy will have a soft landing or whether disinflation will cause further uncertainty.

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