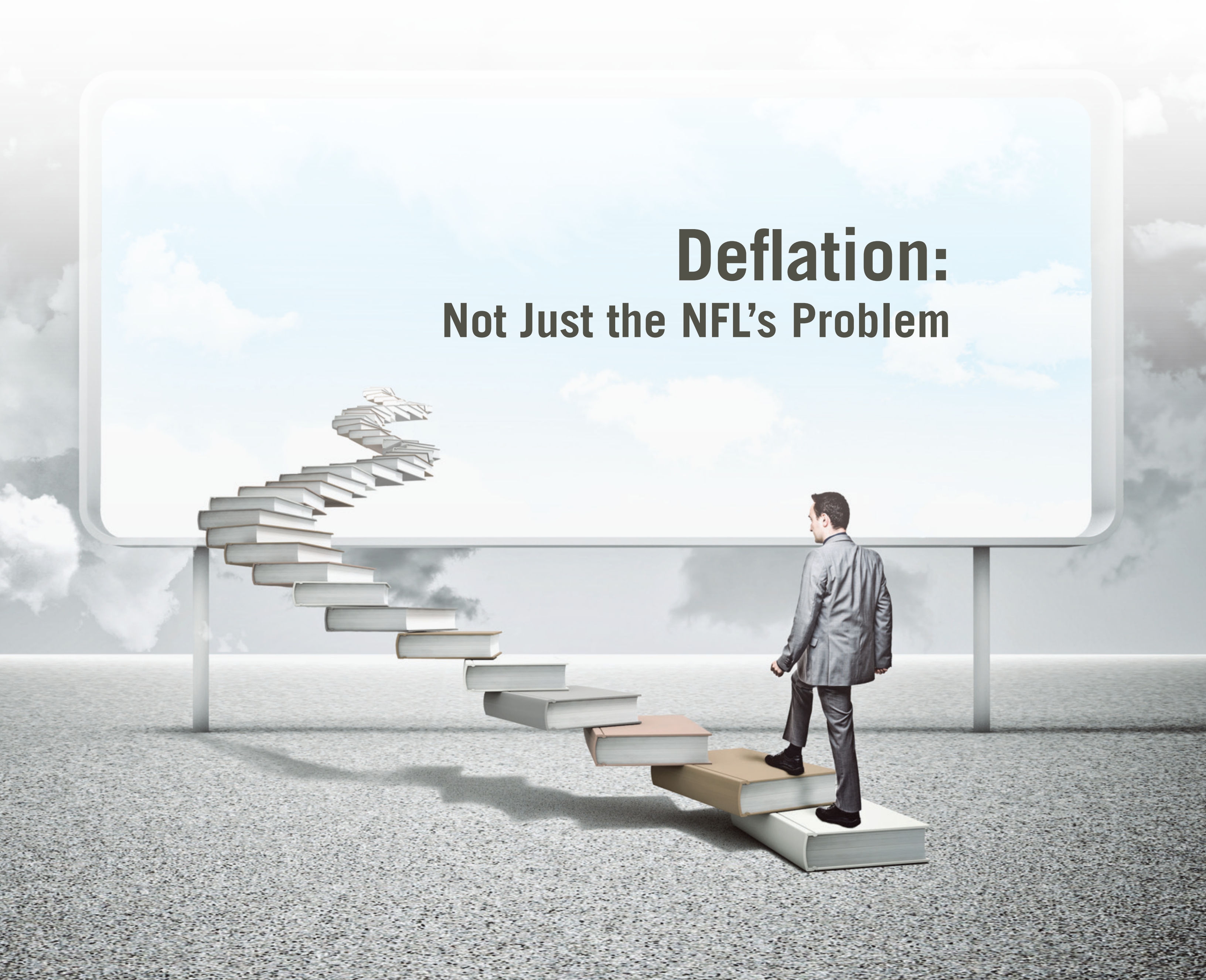
PINNACLE
WEALTH BROKERS

Deflation:
Not Just the NFL's Problem



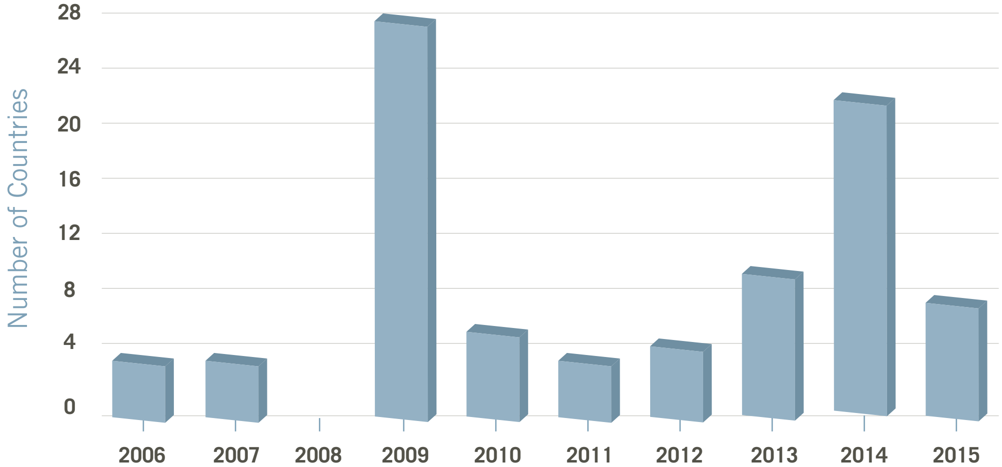
Deflation: Not Just the NFL's Problem

With the "Deflategate" scandal surrounding the NE Patriots now in the rear view mirror after a stunning Super Bowl victory, the accusations that underinflated balls were used in the AFC Championship game have settled. Now a different kind of deflation, that of a downward pressure on prices, is becoming more persistent in the minds of the media and economists alike, and impacting financial markets around the world, particularly in Europe.

The following chart highlights the number of deflation-ridden countries over the last decade with 8 expected in the coming year. This number is significantly less than what we saw during the recession highs of 2009, when 28 countries faced deflation, but still above the 2006–07 levels when less than 4 faced this downward pricing compression. This highlights the persistence of deflationary pressures due to slow growth and weak job creation, particularly in Europe, and the challenge faced by central banks in dealing with the issue. Mario Draghi, the head of the European Central Bank, recently announced a €700 billion quantitative easing program as he continues his head-strong strategy of doing "whatever it takes" to get the European economy moving again.

A Decade of Deflation

Eight countries are expected to see quarterly or annual deflation this year



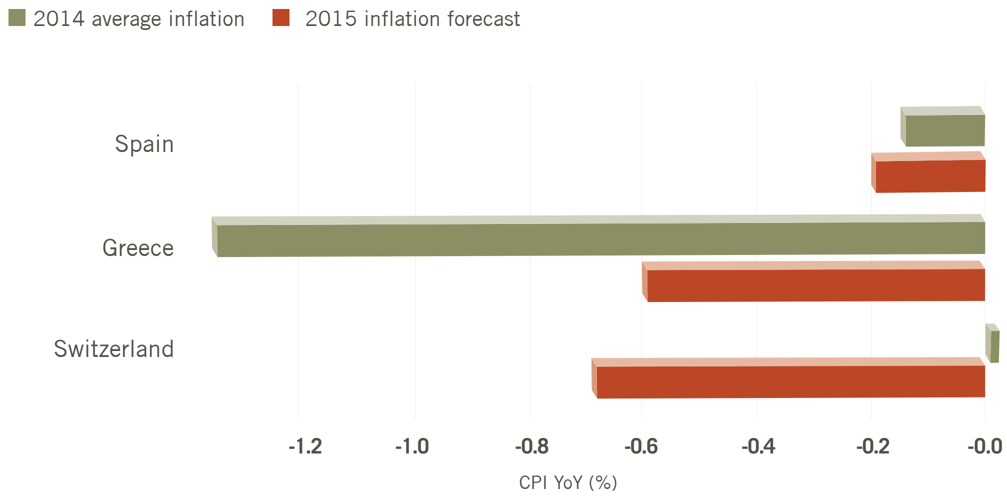
Sources: National statistics offices and Bloomberg surveys.
Euro area aggregate CPI not included.

Bloomberg

All 8 countries expected to experience deflation are in Europe with Greece, Spain, and Switzerland likely to experience the greatest downward pressures.

Deflation Danger!

These three countries are expected to have the worst annual deflation this year.



Sources: National statistics offices. Bloomberg surveys. 2014 averages of monthly CPI figures.

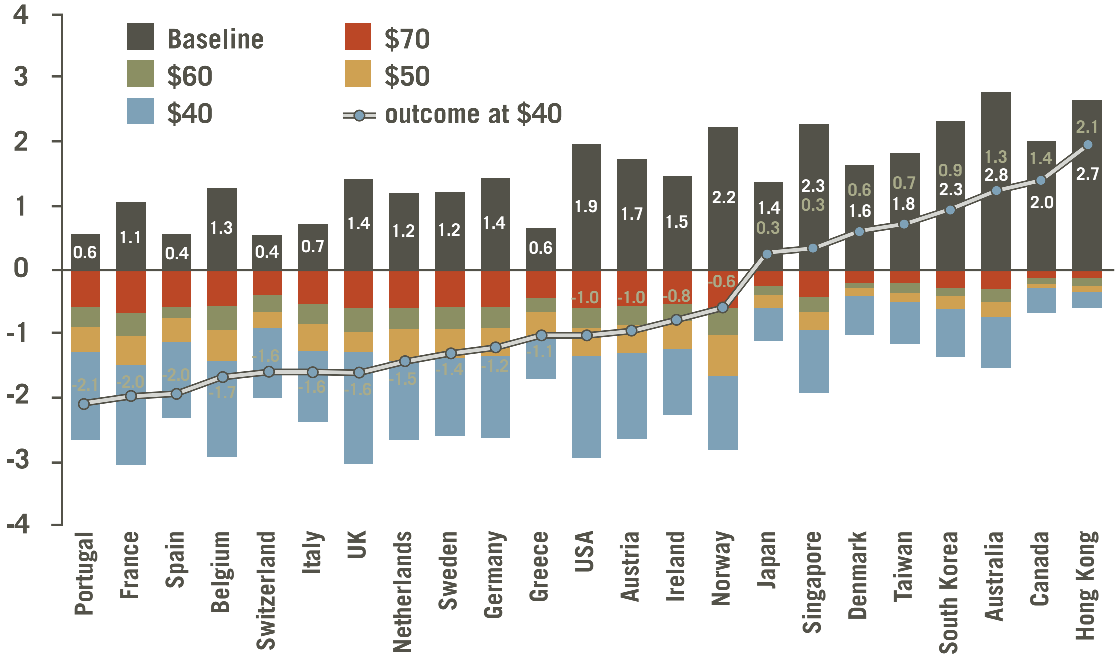
Spain and Greece lead the way with unemployment ranging between 15–22% over the past few years. Switzerland recently removed the cap on their exchange rate, prompting a revaluation of their currency, which has subsequently driven down the cost of imports while also diminishing the competitiveness of their exports.

Weak Oil Prices

The rapid decline in oil prices has only added fuel to the deflationary fire contributing to pressures globally and bringing this issue even farther into the forefront of analyst's minds. The chart below uses $84 Brent as a baseline and suggests that many countries will experience deflationary environments below this baseline oil level. Consumers everywhere will be net beneficiaries as gas prices and home heating costs decline substantially, in turn increasing discretionary incomes. Early evidence suggests that some of those savings will not be spent but rather used to lower debt levels, which have been a growing concern in Canada.

Inflation under baseline & oil scenarios

Baseline and average impact 2015-16



Oxford Economics, Haver Analytics

Impact on Interest rates

Deflationary pressures and the actions taken by central banks around the world have put downward pressure on interest rates. In fact, interest rates have been trending lower for over 30 years in most regions of the world. The current interest rates environment is generally viewed to be at an unsustainably low level with real rates (after adjusting for inflation) being close to zero or in some cased even negative. We can look to Switzerland for an example of extremely low nominal rates as its ten-year treasuries hit a yield of (-0.11 %), caused by investors deflationary expectations for the country's economy as well as a strong currency with the Swiss Franc. All this makes Canadian and US 10-year treasury rates at 1.44% and 1.95%, respectively, look attractive by comparison. The general expectation is that interest rates do need to normalize, but they will likely stay lower for longer than policy makers had initially hoped.

Implications for investors and PWB clients

The implications for the retail investor are that fixed income oriented investments are generally expensive at their current market prices. This has prompted some strategists to suggest the acronym TINA, meaning "There is No Alternative" but equities. We agree that there continue to be some attractive dividend paying companies, but it comes with the added volatility found in the public markets. Volatility has been increasing as investors increasingly worry about the stronger USD impact on earnings, declining oil, geopolitics, and a myriad of other issues causing instability globally. For PWB clients, this brings into focus the advantage of having access to private debt and equity issues that are able to generate stable rates of return, without the volatility of public markets. By leveraging our research team as well as the sheer volume of opportunities we receive as the largest EMD in the country, we continue to explore and vet the best of these deals in order to offer attractive solutions for both you and your clients.