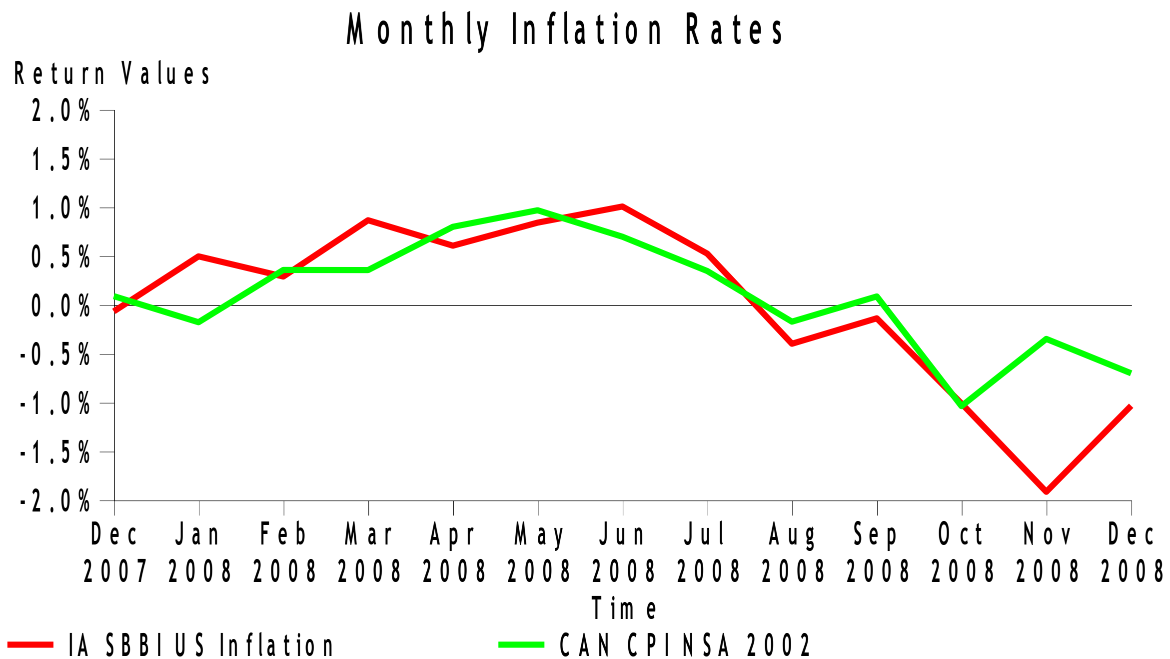
The Money Illusion

The current deep recession has sent consumer prices spiralling downwards and, as illustrated in the following graph, inflation rates are now firmly in negative territory.

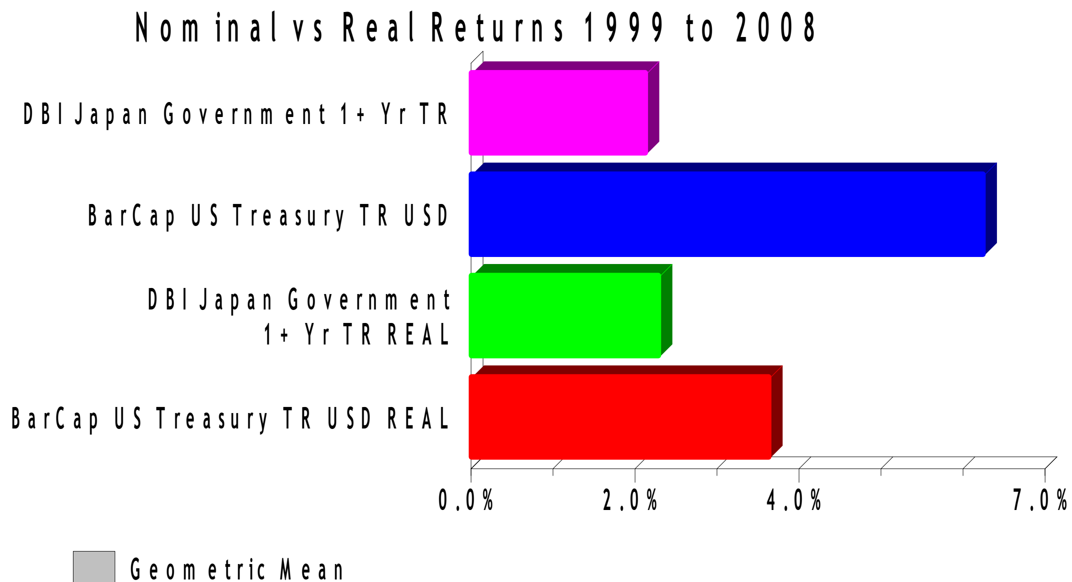


Inflation should remain subdued for some time. The Economic Cycle Research Institute's U.S. Future Inflation Gauge, which estimates future price changes, fell to a 50 year low in January and they note that "there are continued downward pressures on U.S. consumer prices."

In fact, 2009 may be the first year since the early 1950's where consumer prices decline on a calendar year basis. Investors sourly assessing the negligible yields on money market funds and other short-term debt instruments need to keep this in mind. For example, a return of 0.5 percent in a world where prices have dropped 1.5 percent translates into a more remunerative 2.0 percent real return.

Yet, thinking in real dollars is difficult. Numerous behavioural finance studies* have documented that “money illusion” – the tendency of individuals to think of money in nominal rather than real terms – is widespread and persistent. For example, experiments have shown that most people who think that a 2 percent cut in nominal income is unfair also believe that a 2 percent income increase in a world of 4 percent inflation is fair, despite their equivalency in the metric that really matters, purchasing power.

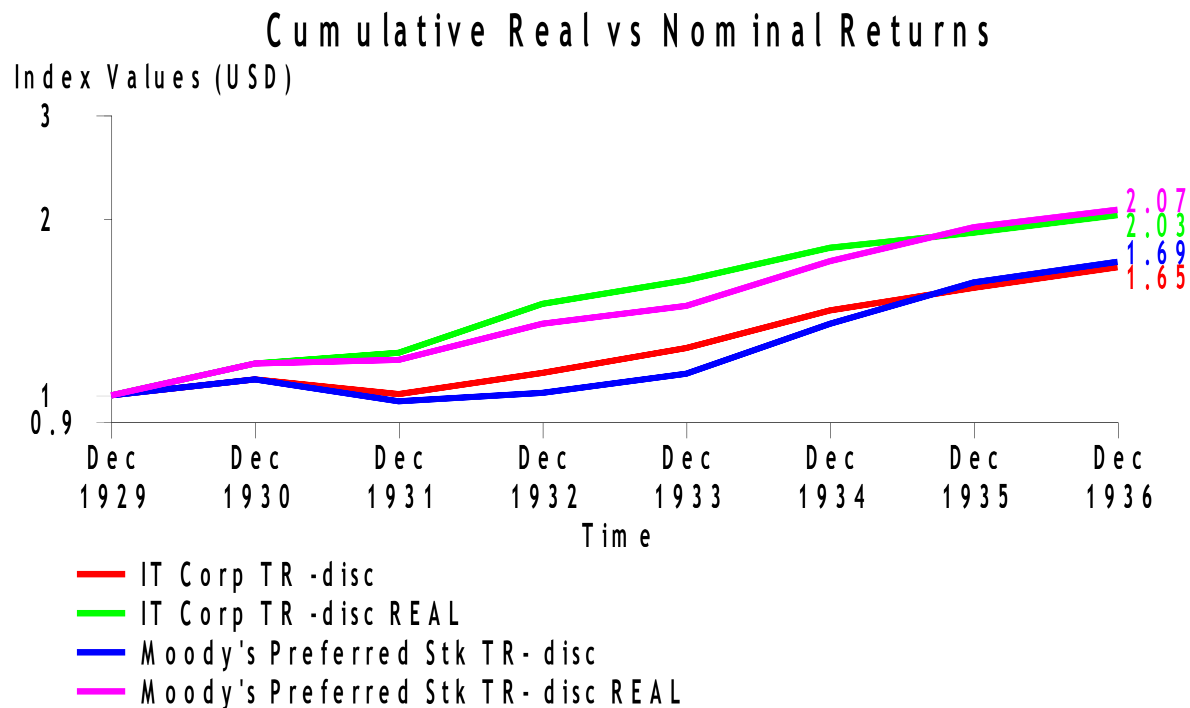
As North America enters a period of deflationary pressure, Japan’s experience with declining prices is instructive with respect to the power of money illusion. At first glance, the 2.15 percent annual return from Japanese government bonds from 1999 to 2008 appears paltry compared with the 6.26 percent return from U.S. Treasury bonds over the same period. Yet, as illustrated in the following chart, the yawning gap between nominal returns (Japan in pink and the U.S. in blue) closes sharply when real returns are compared (Japan in green and the U.S. in red).



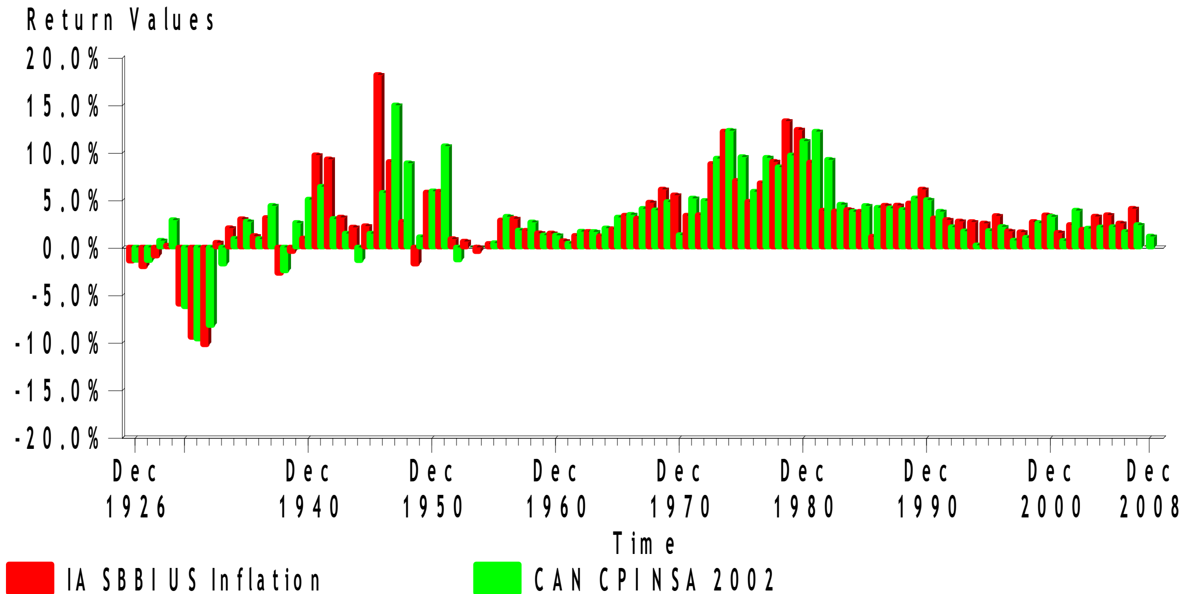
Japan’s mild deflation of -0.16 percent a year actually increased real returns to 2.36 percent while the U.S. annual inflation of 2.53 percent reduced real return to 3.65 percent.

In 2009, and likely even into 2010, real income yields will be enhanced by deflationary conditions. If deflationary pressures become entrenched for a longer period as they did in the early 1930's, preferred shares and corporate bonds will be especially attractive, particularly when the veil of money illusion is lifted.

As evidenced in the following graph, $1.00 invested in intermediate term corporate bonds at the end of 1929 was worth $1.65 at the end of 1936 (in red). On a real basis, however, declining prices elevated the value to $2.03 (in green). The same numbers for preferred shares are $1.69 on a nominal basis (in blue) and $2.07 on a real basis (in pink). Quality fixed income is the investment category of choice for deflationary times.



Looking beyond this recession, however, history suggests that inflation will eventually resume. As illustrated in the graph on the following page, the severe deflation of the Great Depression and the mild deflation of the early 1950's were both followed by a resumption of price increases.

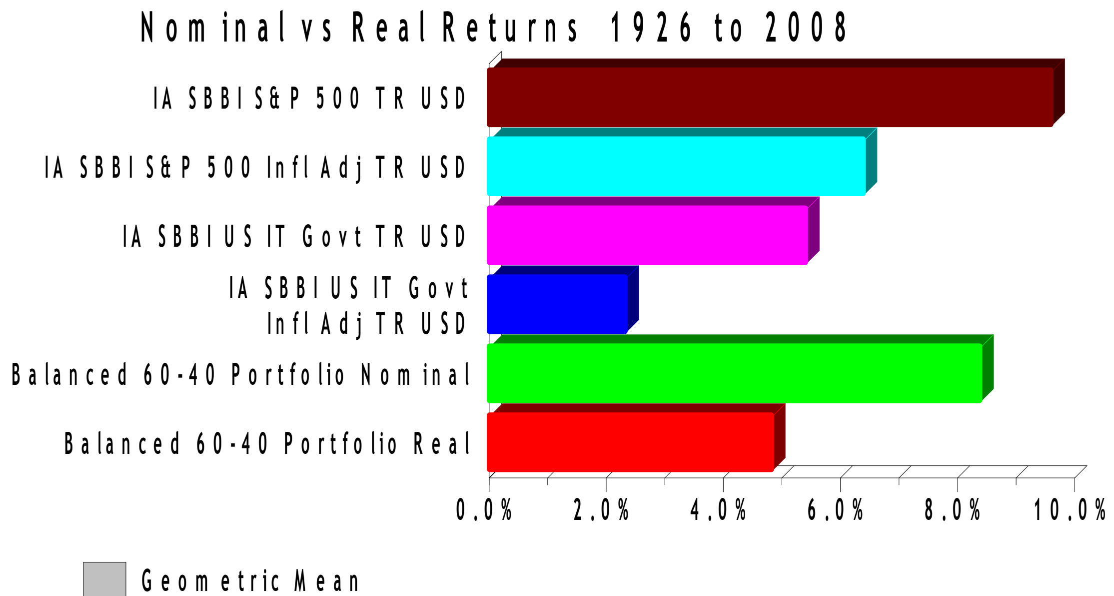


Governments have an overwhelming vested interest in inflation. Since they are massive borrowers, inflation reduces the real value of their debt and tax revenues are inflated by rising nominal prices and incomes. Even central banks prefer modest inflation as deflation reduces the scope of effective monetary policy. A recent International Monetary Fund study identified 23 countries including Canada whose central banks have adopted explicit annual inflation targets. The norm among developed countries is in the 1 to 3 percent range.

Although the U.S. Federal Reserve has not adopted inflation targeting, Chairman Bernanke is supportive of this approach and in practice, the Fed's policies promote modest inflation. The minutes from the Federal Reserve Open Market Committee's December meeting noted the "risks that inflation could drop for a time below rates they viewed as most consistent over time with the Federal Reserve's dual mandate for maximum employment and price stability." Even the Fed worries when inflation is too low.

As Nobel Laureate Milton Friedman used to say, "Deflation is the easiest thing in the world to avoid. You just print more money." And the government's affinity for printing money is why short-term strategies today need to consider inflationary risks over the horizon and that any sound long-term investment strategy has to focus on real returns.

As illustrated in the following chart, there is a material difference between the long-term annual nominal return of large cap stocks of 9.62 percent (in brown) and their real return of 6.42 percent (in light blue). The difference for government bonds is even more striking. Their 5.43 percent annual nominal return (in pink) shrivels to 2.35 percent on a real basis (in dark blue) – a testament of diminution that underscores the need for some equity exposure for even conservative retirees.



Diversified investors face the same issue. The annual return of a balanced portfolio (60 percent stocks and 40 percent bonds) of 8.41 percent (in green) shrinks to 4.85 percent in real terms (in red). Inflation has accounted for over forty percent of a balanced portfolio's historic returns. Unfortunately, many investors under the spell of money illusion don't recognize how modest real returns are and fail to save and spend accordingly.

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*- Interested readers can contact Tacita Capital for the academic sources to which we refer.

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