Much Ado About Deflation

This week will see the release of March'19 inflation data due on Wednesday for Malaysia. After dipping into deflation in January this year, will we see price pressures picking up again? Gan Eng Peng, Director of Equities Strategy & Advisory of Affin Hwang Asset Management offers some perspective on the data and strategies for investing in a deflationary environment

1) Malaysia has experienced its first deflation in January this year since 2009, according to news reports. Can you tell us what is the difference between the deflation in 2009 and today?

The 2009 deflation was caused by a meltdown of financial markets which choked off credit and created a global crisis. Malaysia was not spared.

The current deflation is a function of retail oil prices declining by 10%, following the reinstatement of the weekly retail fuel price mechanism from January 5. Retail oil prices had been held static after the last general election.

This adjustment should have a temporary effect – while the economy is slow we are clearly not in a crisis driven deflationary environment.

2) As deflation is a rare occasion in today's world and investors are not familiar with such environment, could you tell us what does it means to you as a fund manager and investors? What signals does it send to you?

In theory, deflation means lower cost of living for Malaysians as price of goods and services are lowered – this is what the Rakyat has been asking for. But that is only half the equation, as in reality, it comes with a very slow or recessionary economy – which means wealth effect is poor, job insecurity and balance sheet erosion. If the government keeps focusing on lowering the cost of living without correspondingly driving economic growth, we can end up in such a situation.

A deflationary environment is bad. Asset prices are generally dropping. As a result, people have less propensity to invest as they can get assets cheaper later. Wealth might still be intact but the velocity of money is slowing. Animal spirits would be slaughtered. This creates a negative feedback loop towards a slower economy. Hence the need for government stimulus in the form of less restrictions or tax, more spending or easier monetary conditions (lower interest rates).

3) Does deflation affect fund managers from an investment strategy, stock picking and asset allocation perspective? Do you invest differently in a deflationary environment?

Deflation is generally bad for equity markets as markets are priced-off growth, the lack of which deflates stock prices. The pain would come during the adjustment period as the economy goes into deflation and markets adjust. The investment strategy in such a situation would be a wholesale reduction of equity exposure.

Deflation is bad for banks. Their collateral for loans like property assets is generally shrinking in value, making the loans riskier as collateral value drops in relation to outstanding debt. People have less desire to spend and there is less economic opportunity to invest, leading to lower demand for loans.

The segment that might benefit are high yielding stocks or REITs as interest rates would need to be lowered to stimulate the economy. This would create capital appreciation as yields get compressed.

If rates are reduced drastically, our currency would be weakened also assuming global conditions are benign. In such a situation, companies that derive non-Malaysian revenue would benefit. This would be your exporters.

4) People often say that a deflationary environment is not good for investors as prices are suppressed and companies are not able to raise prices. Profits and earnings will come in lower. Is this the case in Malaysia for now? And in your view, is deflation always bad for investors?

To be clear, we are not in a deflationary environment. We are in a slowing economy that has translated into negative profit growth for the aggregate stock market in 2018 and negligible growth in 2019. The good news is that there are some tools left for the government to pull to drive us out of this funk. This would include cutting interest rates, coming out with a cohesive growth strategy, loosening our austerity drive and generally be more business friendly. The latter two might take some political u-turning.

5) When do you expect the CPI to start picking up again? And when that happens, what does it tells you?

With the rebound in oil prices, we should expect inflation to start rising from June onwards. The Finance Minister, Lim Guan Eng has suggested that full year inflation will come in at 1.6% - 2.0%, which also reflects this view. However, it is a significantly lower number compared to the official CPI forecast range of 2.5% - 3.5%, which was announced in November 2018.

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