

## DECODING DEFLATION

In many ways, the industrialized world is now experiencing what Japan went through in the early 1990s: A severe banking crisis leading to a deep economic recession and persisting asset price deflation. The rest of the industrialized world may be turning Japanese faster than we think.

Central bankers around the world have learned an important lesson from Japan - not to fall behind the curve. In the early 1990s, Japanese monetary authorities reacted too slowly to the intense build-up in deflationary forces. This time, the central bankers, led by the U.S. Federal Reserve, have reacted more promptly. Interest rate cuts have been delivered five times faster.

While central banks have been a lot faster to cut interest rates aggressively, the build-up in deflationary pressures has been just as fast. Deflation (falling prices) has been intensifying in many asset prices and overall consumer price inflation is decelerating at a worrying clip across the globe.

In many ways, since the early 1990s Japanese investors have been dealing with this challenging situation that is characterized by:

- More frequent, more pronounced and shorter economic cycles, and by ricochet effect, more cyclical, more volatile financial markets.
- Lacklustre returns on domestic portfolios.
- A strongly negative correlation between bonds and stocks.

In this type of environment, the optimal asset mix strategy would seem to favour bonds over equities, despite the exact opposite signal provided by traditional valuation metrics. However, overall domestic portfolio returns would still fail to add value.

To add value, Japanese portfolio managers turned to markets with better growth prospects. In the early 1990s, that meant investing in the United States and in the rest of the industrialized world. Investing abroad certainly made a lot of sense. Both international bonds (essentially U.S. and Europe) and international equities provided hefty returns for the Japanese throughout the 1990s.

Today, shifting exposure to markets with better growth prospects means increasing exposure to the emerging world.

In Canada, the case for international diversification is even stronger given the currency dynamics typically at work in the volatile environment we are now experiencing. The Canadian dollar typically weakens when global financial tensions intensify, offsetting the losses on foreign assets.

In the current deflationary environment, international diversification alone isn't enough. Tactical asset allocation and overlay strategies become essential. CIBC Global Asset Management offers both tactical asset allocation and overlay strategies.

With more diversification, tactical asset allocation – the periodic rebalancing of the portfolio – is in order. Overlay management helps to maintain the long-term goal of asset allocation by addressing inefficiencies that: could increase the risk of the overall portfolio; could have negative tax effects; or could unbalance the investor's positions. It also separates the management of currency risk from the asset allocation and security selection decisions.

The implications for portfolio management are huge. To add value during deflationary times, international diversification and overlay and tactical asset allocation strategies are fundamental.

