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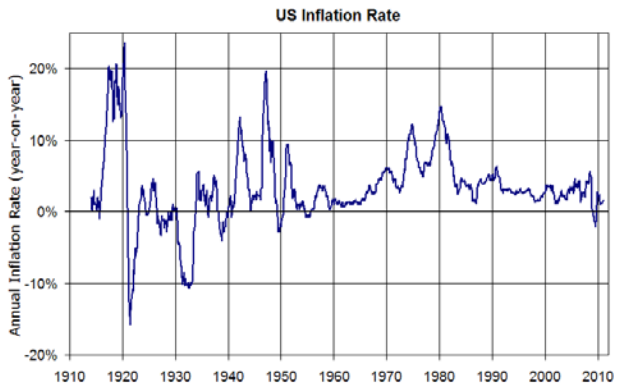
For almost anyone who grew up in the second half of the last century, and particularly anyone who was a consumer of goods and services in the 1970s, the idea of deflation (a generalized decline in the prices of goods and services) is probably nothing more than some academic concept that you needed to learn in order to pass the test for some long-ago economics course, and something which you always felt very confident that you would never encounter in the real world…at least, not in the United States.

After all, aside from a brief period in the midst of the 2007-2008 financial crisis, America has not experienced deflation on any kind of prolonged basis since the 1930s. Similarly, while not so rare as is deflation, prohibitively high inflation is also quite unusual in free-market economies, where prices are determined by the relationship between supply and demand.

Aside from the 1940s, when it was the by-product of World War II-related shortages, the United States has only experienced one period of damagingly-high inflation in almost 100 years (the 1970s), which was largely a result of the O.P.E.C. cartel conspiring to drive all of its competition out of business (much like what is happening today) and then constricting supply. The resulting quadrupling of oil prices created a global inflationary spike.

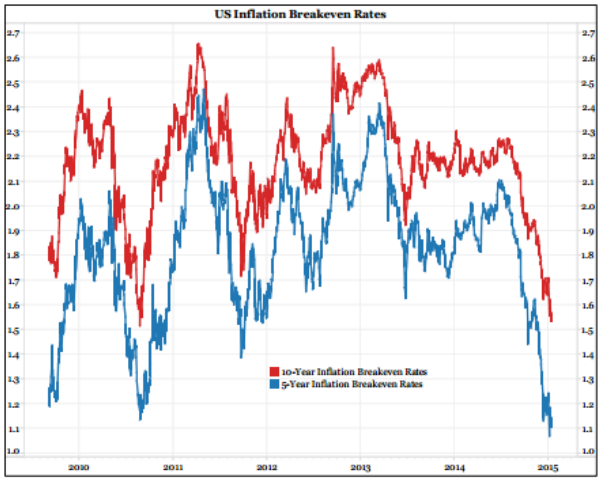
Indeed, one can make a strong argument, based upon the last 100 years of history that, when allowed to work without outside interference (or illegal activities like price collusion that corrupt the supply/demand dynamic), capitalism normally does a remarkable job of balancing supply and demand in a way that makes extremes in either inflation or deflation really quite rare. At the same time, we know that, when markets are distorted by non-free-market influences, investors will often seek to exploit the resulting imbalances for profit, often with very negative longer-term implications, including excessive inflation or, even worse, deflation.



On the far left side of the chart, you will see the World War I shortage-related inflationary spike and the 1920-1921 Depression, which was catalyzed by troops returning from the war, which created a surge in the civilian labor force and more unemployment and wage stagnation and the monetary policy being employed to battle war-related inflation.

An excellent example of this occurred on the legislative front, starting during the Carter administration, when the government decided that, as a matter of policy, everyone should own a home, essentially whether they could afford it or not. To this end, banks were required to make a requisite percentage of loans to non-credit-worthy borrowers (the advent of the sub-prime market) and banks responded by packaging these loans together and selling them to investors.

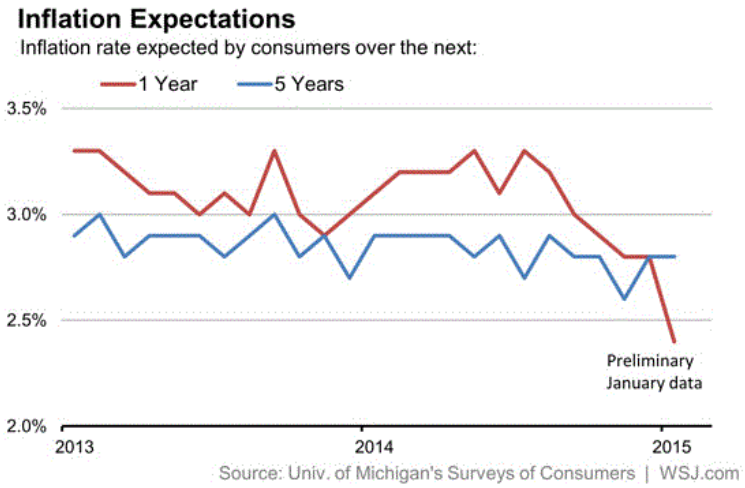
This practice was greatly exacerbated by legislation requiring Fannie Mae and Freddie Mac to essentially buy as much of this sub-prime paper as the banks could produce, which first led to a housing bubble (i.e. inflation) and then ultimately catalyzed the financial crisis and a resulting period of deflation (2007-2008).



This experience also helped to reaffirm one of the other lessons from economic and market history which is that, while outside influences can distort the free markets pricing mechanism very effectively over limited periods of time, the factors of supply and demand will ultimately determine the longer-term price equilibrium.

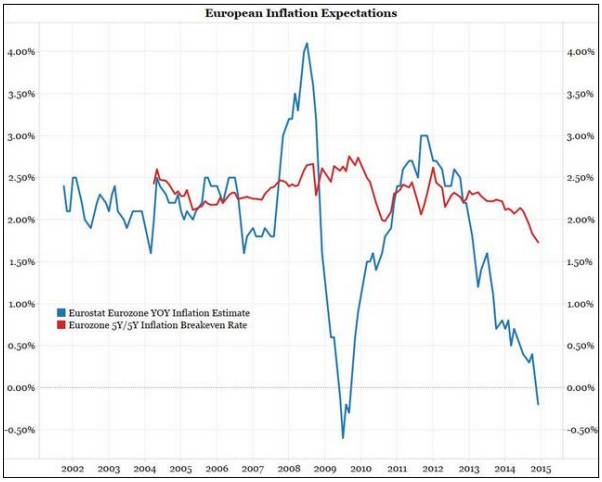
This fact was just reaffirmed over recent weeks by the decision on the part of the Swiss National Bank to un-peg ("un-tie") the value of the Swiss franc from that of the Euro currency, against which it had been artificially fixed. This un-pegging caused the franc to instantly increase in value by 30%. It also pushed many Swiss interest rates well below 0% and may even ultimately catalyze massive mortgage defaults across much of Europe, as many Eastern European (and even British) mortgages are denominated in Swiss francs. This means that the mortgage debt of anyone with a Swiss franc-denominated mortgage just increased by 30%. Reportedly, Switzerland quite simply had no choice in the matter. The Swiss National Bank could no longer afford all of the money that it was costing them to distort the currency markets and keep the franc pegged to the Euro currency.

Another example can be found in the recent housing bubble in the United States, which was greatly magnified by former Federal Reserve Chairman Alan Greenspan's decision to forcibly keep short-term interest rates unjustifiably low for far too long, as he sought to distort the business cycle and reduce the amplitude of the traditional boom and bust business cycle. While done with the best of intentions, this effort to distort the pricing mechanism of interest rates greatly exacerbated the housing bubble, which was ultimately at the core of both the global financial crisis and the resulting deflationary period.



Of note, the Fed responded by reflating the economy with yet even lower interest rates and even more money supply. Just like Europe and Japan, the Fed is using the same tools to restart inflation and battle deflation that were previously responsible for the inflating of the credit and housing bubbles, the popping of which caused the very deflation that they are currently trying to overcome. Clearly, the gods of finance have a sense of humor and an appreciation for irony.

The good news is that, while all of this domestic stimulus will ultimately need to be unwound, it is at least having the desired effect on the domestic economy, which is clearly the envy of the industrialized world, albeit well-below average for most economic recoveries.



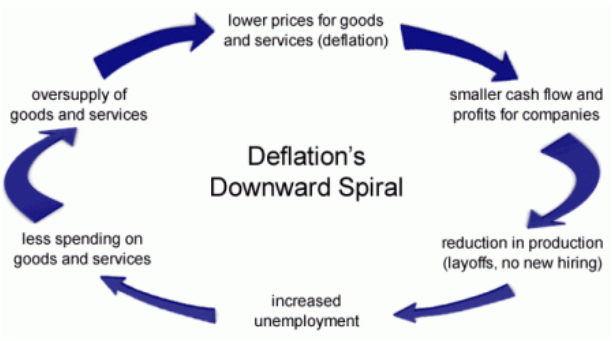
The bad news is that the after-effects of two classic examples of market distortion continue to threaten the health of the global economy. The first is Japan, which is still trying to emerge from an almost twenty-five-year-long deflationary cycle that was a byproduct of the uniquely Japanese style of crony capitalism that dominated the Japanese economy through the 1970s and 1980s, and which allocated capital to the well-connected instead of those projects determined by the marketplace to deserve funding (thus eliminating the pricing mechanism altogether). This created massive speculative bubbles in their real estate and equity markets.

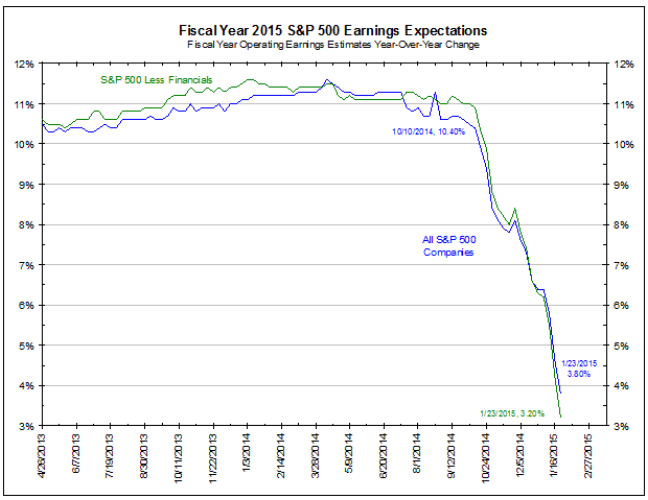
The second example is the European Union, which is distorting the pricing mechanisms in nineteen different economies by imposing one currency and one common monetary policy across all of them. The result is a situation under which virtually every country has a currency, interest rate and economic dynamic that is vastly different than they would be if they were set by the markets based upon each country's unique fundamentals. The resulting lack of flexibility has created a condition of stagnation and deflation that is pervasive across the region and, along with similar conditions in Japan, is starting to "export" deflation to other countries across the globe.

Granted, for those of us who lived through the hyper-inflationary period of the 1970s, experiencing a little bit of deflation probably has a certain appeal to it, at least on the surface. However, deflation is much more nefarious than inflation for a variety of reasons ranging from the disastrous impact that it can have on an economy to the fact that there is very little that the world's central banks or central governments can do to emerge from it, particularly in situations like the present, when interest rates are already near 0% and sovereign indebtedness is already so high that government spending and other types of fiscal stimulus are very challenging at best.

In addition, once falling prices develop into a general expectation, it depresses consumer spending, as there is no reason to buy something now when it is likely to soon be less expensive. You can imagine how damaging this mindset would be in a country like the United States, where consumer spending makes up about 70% of the size of the economy (GDP). Deflation affects business spending in a very similar way. In fact, in the most recent Purchasing Manager's Survey, which was weaker than expected, respondents noted that they were already delaying purchases due to their expectations that prices will be lower in the future.

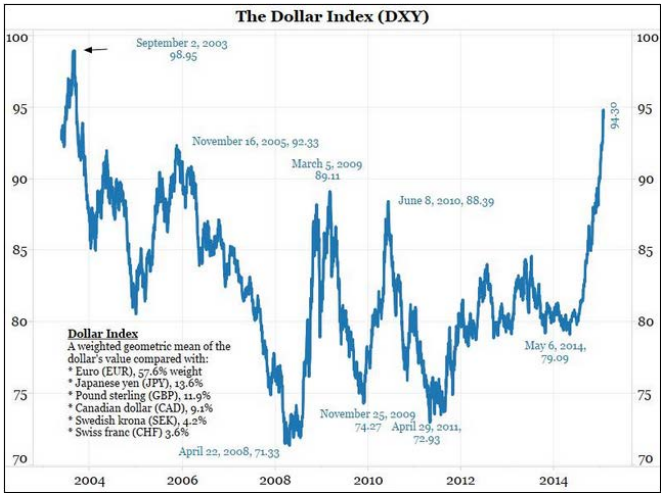
Further complicating matters is the fact that deflation causes companies to lose their pricing power (their ability to raise prices). That makes it harder for them to grow profits. In such an environment, if companies want to increase market share, they have to reduce prices, which compounds the deflationary pressures. Similarly, if there are lower profits, there is less money to be paid to workers in the form of higher wages. When employees don't get the raises they were expecting, they cut back on spending even more, further compounding the problem. On top of everything else, deflation causes debt to become a larger portion of every borrower's balance sheet, due to the fact that asset prices are dropping while the debt taken on to acquire those assets stays the same.





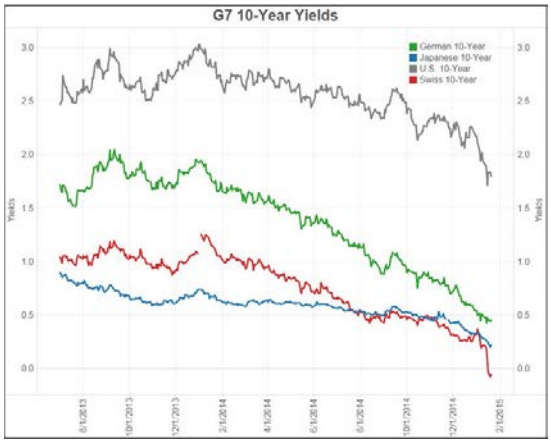
While the risk of deflation in the U.S. is not such an imminent threat as it is in Europe and Japan, the domestic economy and capital markets are certainly feeling an indirect impact starting with earnings. Analysts' expectations for 2015 S&P 500 earnings are absolutely collapsing, and it seems that almost every company that has announced disappointing earnings for the fourth quarter of 2014 are at least partially blaming the soaring value of the U.S. dollar, which is both making U.S. products less price competitive in overseas markets and lessening the value of foreign earnings that are converted back to dollars.

This issue is hardly surprising when you consider that an estimated 45% of earnings from companies included in the S&P 500 Index are derived from overseas sales.



The dollar is strengthening for many reasons, including the facts that the U.S. has 1) the world's strongest industrial economy 2) the highest yields on "risk-free" sovereign debt, and 3) the only central bank (with the possible exception of England) that is reducing stimulus just as most of the world is accelerating their stimulus programs. Indeed, since money is fungible, we expect for much of the money being created through quantitative easing (money printing) in Europe and Japan will end up flowing into the U.S., which should help to support domestic equity, debt and real estate prices.

However, there is another very important reason why the dollar is strengthening against the currencies of its trading partners. It is because there is a growing "currency war" under way, where other countries are actively taking steps to debase their currencies against the dollar, in order to stimulate their respective economies (by making their exports more price competitive), while simultaneously creating some healthy inflation to help offset deflationary pressures like falling energy prices and high unemployment.

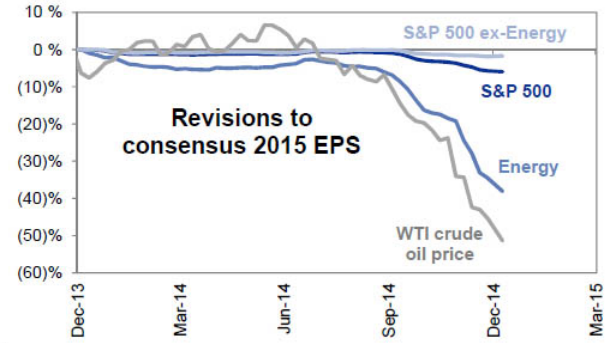


It is not just Japan and Europe. In January alone, fourteen different countries reduced their interest rates to weaken their currencies and lessen deflationary risks. Further, there are six European Union countries that pay less than one-half of one percent on their 10-year government bonds and the Swiss 10-year note actually pays a negative yield (as do 2-year notes in Germany, Japan and Switzerland).

Indeed, according to JP Morgan, $3.6 trillion of government bonds traded at negative yields last week, which is equal to 16% of the sovereign bond universe. This keeps U.S. sovereign bond valuations quite compelling on a relative basis, and should help to keep domestic rates low and debt prices very high. We believe that it should also flatten the yield curve (reduce the difference between long-term and short-term rates), which is historically quite negative for the profits of most financial services firms.

As noted above, while the world's deflationary risks are still concentrated in Europe and Japan, the U.S. is certainly not immune, as is further evidenced by the recent and growing signs of domestic disinflation (a slowing in the rate of overall inflation). For example, domestic consumer prices are rising at the slowest pace (during a period of positive economic growth) in the last half-century. In addition, we just witnessed a drop in domestic hourly earnings (actual wage deflation) in the latest jobs report.

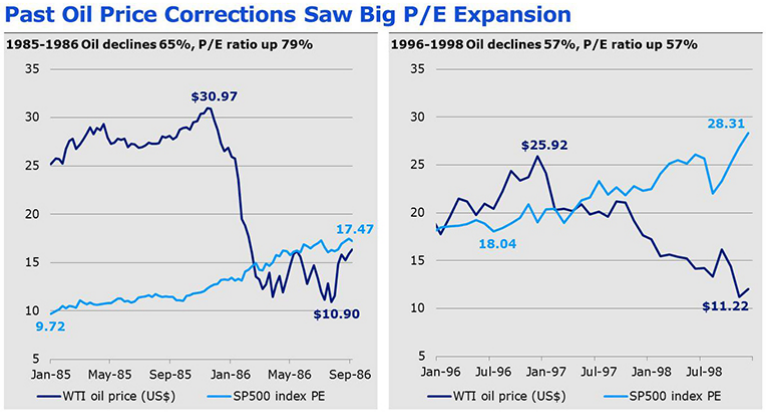
Exhibit 1: Revisions to Energy earnings have weighed on S&P 500 estimates as of January 8, 2015



Source: FirstCall, I/B/E/S, Compustat, and Goldman Sachs Global Investment Research.

From an equity investor's perspective, the most direct impact of these deflationary forces are reflected in earnings, which are being dragged down by the aforementioned stronger dollar and weak demand from Europe and Japan. Another deflationary impact on overall earnings is likely to come from the anticipated collapse in energy company earnings, which make overall equity market valuations appear very expensive in the current environment.

On the other hand, it is true that big declines in oil prices have historically allowed equity markets to trade at much higher price-to-earnings multiples (valuations), which could prove to be an important bullish offset to the anticipated slowdown in earnings growth.



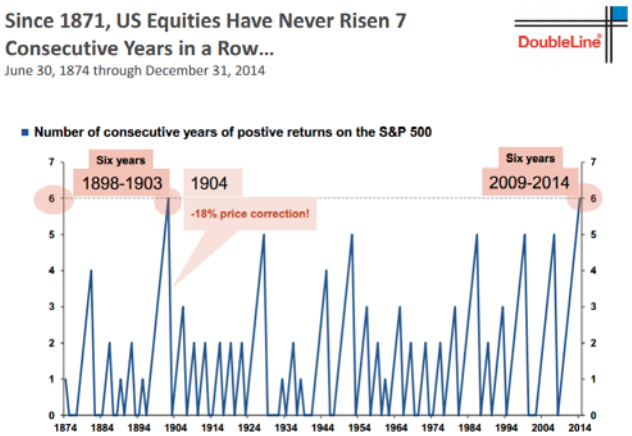
Source: Bloomberg L.P. Past performance is no guarantee of future results. An investment cannot be made directly in an index.

At first glance, logic would dictate that a deflationary environment would portend a terrible outcome for equities. After all, the 1920 Depression, the Great Depression and the 2007-2008 global financial crisis, which were the only major deflationary periods within the last 100 years, were all awful periods for the equity markets.

There is virtually no doubt that deflation is a negative for equity prices. However, what we consider to be less certain is whether or not the negative impact of deflation is so severe that it makes an equity bear market inevitable, or is it possible that other macroeconomic factors like low interest rates, European and Japanese quantitative easing, and trillions of dollars of Fed-induced excess liquidity sloshing around the financial system are more important to equity investors than are deflationary risks.

When answering this question, it is important to remember that the best time this century to invest in America was at the depths of its deflationary period. While we do not expect Europe to enjoy quite the benefits of QE that we witnessed in the U.S. (because Europe has less of a stock ownership culture and because the European equity markets already rallied 50% before the advent of QE), we still expect for Europe to provide one of 2015's most compelling investment opportunities.

At the same time, we expect for the rising dollar and the relative attractiveness of U.S. assets to drive a substantial amount of money being created by foreign quantitative easing programs into America's capital markets. This should be a very bullish offset to many of the aforementioned concerns, which may allow both domestic and foreign equity markets to buck the deflationary trends.



There is little doubt that the domestic equity markets are a bit long in the tooth; that valuations are a bit stretched, and that the historic odds are against the domestic markets going up for the seventh year in a row. However, that does not diminish our beliefs that 2015 will include many opportunities for investors to make money, and that we are likely to return to an environment where tactical allocation and individual securities selection can add real value to portfolios for the first time in years.