Stock slaughter

BY ALISTAIR BARR, MARKETWATCH — 02/13/09

SAN FRANCISCO (MarketWatch) -- As 2009 began, U.S. dairy farmers slaughtered more than 70,000 cows in one week to fight slumping prices.

Herds are being culled at the fastest rate in almost two decades as the recession withers away consumers' demand for everything from frothy cappuccinos at Starbucks (**SBUX**) to mozzarella-covered pizzas at Domino's (**DPZ**). In January alone, milk and cheese prices plunged by at least one-third.

Similarly painful adjustments are playing out around the world as companies try to slash production and cut jobs in the face of falling demand and waning pricing power.

The problem is that, as more companies hunker down, demand may weaken further, spurring another wave of downward pressure on prices that would usher in a prolonged period of deflation.

"The combination of credit-crunch deflation and recession is forcing companies to conserve cash by firing workers and slashing capital spending," said investment strategist Ed Yardeni. "That should work for one company, but when they all do it, it just exacerbates the situation by cutting demand all over again."

Many investors believe that a lengthy bout of deflation is unlikely. But if consumer prices do indeed fall for a long time, the result is likely to be a disaster for much of the stock market, investment professionals say.

Investors could minimize their losses in stocks -- and maybe even capitalize a little on the situation -- by paring their portfolios of the most vulnerable assets while steering toward sectors that are more resilient to a deflation wave.

Companies that may suffer less include those with costs that fall more than the price of their products, such as Dean Foods (**DF**), and firms that help consumers save money, like Wal-Mart Stores (**WMT**) and McDonald's Corp. (**MCD**).

But many sectors including banks, metals companies, retailers and manufacturers would likely be crushed by sustained deflation.

"Sometimes an entire asset class is not a good idea," said Kevin Harrington, chief economist at San Francisco-based Clarium Capital.

Clarium, which runs a $2.24 billion global macro hedge fund, is avoiding stocks, while betting on gains in the U.S. dollar, which Harrington describes as "implicitly a deflationary trade."

No global macro hedge funds were bullish on U.S. equities, according to a survey in early February by consulting firm Greenwich Associates. That was down from 46% in January and 62% in December.

The lowest level of interest in U.S. stocks before that was 8% in October 2007, just before the Standard & Poor's 500 index (**.SPX**) began a 45% slump.

"It's not a question of if. Deflation is upon us," said John Brynjolfsson, chief investment officer at Armored Wolf LLC, a global macro hedge fund in Aliso Viejo, Calif. "It's a question of how bad it will get."

Steven Bell, a former Deutsche Bank economist who runs a global macro hedge fund at London-based GLC Ltd., has been betting against European and Japanese stocks, while buying two-year German government bonds.

"Deflation is a serious threat," he said. "You have to say that all companies would lose in such an environment, but some would lose less than others."

In contrast to equities, deflation typically boosts long-term government bonds because their fixed payments become more valuable as the price of goods and services fall.

Japan

When Japan suffered its most severe bout of deflation, from October 2000 through January 2003, only one sector of the nation's stock market -- electric power and gas shares -- posted gains, according to Morgan Stanley (**MS**).

Shares of non-ferrous metals producers, communications, banks and services companies dropped more than 60% during the period.

And there's a worrying difference between Japan's experience and the current predicament of the U.S.: The Japanese had lots of savings when the country descended into its deflationary recession, but U.S. consumers are now mired in debt.

"The societal effects were not nearly as dramatic as we're experiencing now in the U.S.," said Brian McAuley, chief investment officer at hedge-fund firm Sitka Pacific Capital Management LLC. "People had much more to fall back on in Japan, while our consumption is falling dramatically."

McAuley is investing in gold and gold mining companies, while keeping his hedge funds' equity exposure at zero.

He's expecting more stock market losses, with the Standard & Poor's 500 index possibly falling to 650 points, more than 20% below current levels.

Deflation scare trades

Morgan Stanley strategist Ronan Carr recently advised investors to keep most of their money in cash and gold.

Gold is usually considered a good hedge against inflation, rather than deflation. However, Carr said the precious metal would likely provide protection in either scenario.

Banks should be avoided, partly because deflation increases borrowers' debt in real terms, making it harder for them to repay loans, Carr explained.

Mining companies carrying lots of debt, such as Xstrata, may also be losers because the real value of their interest payments would rise while the prices they can charge for the metals they produce falls, Carr said.

Other so-called cyclical stocks, such as carmakers, should also be avoided, he added.

Relative winners include companies that generate strong cash flow and have little debt. Industries that have pricing power and are protected from new competition could also survive better. Tobacco companies, drug makers and property and casualty insurers fit those criteria, Carr says.

Already declining

While debate swirls over whether deflation or inflation will emerge over the long term, prices are already falling in the U.S.

The consumer price index fell 1% in October, the most since the Bureau of Labor Statistics began publishing seasonally adjusted prices in 1947. The CPI slumped 1.7% in November, another record, and 0.7% in December.

Morgan Stanley estimates that by July, U.S. consumer prices will have fallen 3% from a year earlier. Merrill Lynch sees the CPI down by the same amount by the third quarter.

Once falling prices form a trend, it's difficult to reverse, partly because consumers are encouraged to save rather than buy. That dents demand and sales, potentially inflating companies' inventories and triggering more discounts.

"Potential buyers realize that they can negotiate even lower prices simply by waiting," Brynjolfsson said.

Fixed debt payments get larger in real terms, which means any credit problems impacting the financial system only get worse, he added.

The auto industry has already been buffeted by deflationary winds.

Most new car purchases are at least partly paid for with loans. The transaction results in two costs for consumers -- the extra money for the loan and the impact of an asset that begins to lose value the moment it's driven off the lot.

But in a period of deflation, the cost of the loan increases because the debt payments rise in real terms.

The result has been a plunge in new car sales which has pushed U.S. automakers General Motors (**GM**), Chrysler and maybe even Ford (**F**) to the brink of bankruptcy.

One carmaker, South Korea's Hyundai, is trying to tackle the problem by letting buyers return vehicles, at no cost in most cases and with no dent on their credit rating, if they lose their job or income within a year.

"That's a direct response to the deflationary psyche of buyers," Brynjolfsson said.

Cutting capacity

Airlines performed relatively well last year when their costs fell as oil prices slumped. However, demand for flights started dropping too, pushing ticket prices down 11% from their August high, according to Yardeni Research.

"Airlines benefit when oil prices decline, but they lose if conditions are such that no investment bankers are flying to see their clients," GLC's Bell said. "Space in first class and business class has been dramatically reduced."

The parent companies of American Airlines (**AMR**) and United Airlines (**UAUA**) said in January that they would cut capacity further this year to adjust to try to halt the decline in airfares.

The retail sector has been particularly hard hit as slumping demand forced many companies to slash prices to whittle down ballooning inventories.

Costco Wholesale Corp. (**COST**), one of the world's largest retailers, sent a shudder through the industry in early February when it issued a big profit warning. The company said it cut prices aggressively to drive sales, but that took a chunk out of margins.

Eggs and butter prices were chopped 10% to 20% and milk prices were slashed more than 20%, Chief Financial Officer Richard Galanti said.

"Arguably, a good chunk of that is short-term, as long as we don't live in a recession forever and as long as we don't see huge deflation," he added, during a conference call with analysts.

Even luxury retailers have slashed prices. Saks Inc. (**SKS**) cut designer-clothes prices by 70% before the holiday

shopping season. Still, the department store operator reported a 24% slump in January sales, partly because shoppers continued to buy sale items, rather than regular-priced merchandise.

"What the sector will have a tough time doing is returning to full-priced business," said Brian Sozzi, an analyst at Wall Street Strategies. "Consumers are now trained to expect discounts."

Nuts and chips

Other companies traditionally considered resilient in recessions have also been hit by deflationary troubles recently.

Kraft Foods (**KFT**), the world's No. 2 food maker, reported a 72% drop in fourth-quarter profit as it struggled to deal with declining food prices.

In January, Kraft was forced to cut prices on its Planters nut snacks after it lost market share. When Kraft raised prices last fall, its rivals didn't.

Technology companies are used to falling prices, but the recent drop in chip prices has been so severe that several companies have suffered.

The price of DRAM, a memory chip commonly used in personal computers, slumped 77% from May to December last year. NAND flash chips, used in cell phones and digital cameras, have fallen 62% in price during the same period, according to iSuppli.

Shares of Micron Technologies (**MU**), a leading DRAM supplier, dropped 64% last year, while SanDisk (**SNDK**), one of the largest NAND flash makers, slumped 71%. Qimonda AG, a big German DRAM maker, went bust in January.

Possible winners

Some companies may benefit from deflation if their costs fall faster than the price of the products they sell.

Take Dean Foods. The company buys milk from dairy farmers then processes it, distributes it in refrigerated diesel trucks and sells it to grocery stores and other food retailers.

The recent drop in milk prices and a 106% slump in diesel fuel in the past year have cut Dean's costs dramatically. That's made up for declines in the price of the dairy products it sells, improving profit.

As recently as Wednesday, Dean Foods said that fourth-quarter profit more than doubled and issued a bright forecast for 2009.

Other companies that offer consumers ways to save money may also avoid some of the damaging effects of deflation.

Sitka's McAuley said Wal-Mart may benefit as shoppers become thriftier. Meanwhile, fast-food giant McDonald's has remained resilient in recent months.

"Companies that provide consumers with the opportunity to save some money and still get fairly good service and products may do OK," Yardeni said.

Even so, Yardeni and McAuley warn, if deflation lingers for a long time, there would be few such examples for investors to consider.

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