



The 'D' Words - Deflation and the Dollar

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- Autos widen as corporate profitability and deflation concerns weigh.
- Telecom, tech and power may be the battle-tested sectors if dis-inflation is the fear.
- U.S. dollar weakness favors debt over equities.

Corporates ended the week on a positive note and are out only 2-3 bp so far on the month.

The biggest losers of the week were the autos, which widened 15-20 bp as the D word (deflation in this instance) was increasingly bandied about in the financial press. Any gloomy forecast of deflation would stall a recovery in corporate profits and certainly lead to fresh rounds of restructuring charges and related outlays. As industries look to wring out excess capacity to potentially restore some pricing power as well as scale down unit costs. Autos get hit on several fronts. First in the technical realm, autos are the spread product hedge vehicle of choice, and if you get worried on the macro front, the practice seems to be to simply sell auto paper. That reaction (and the anticipation of that reaction) often falls hard on autos and has heightened volatility in auto paper on the up and downside.

From the standpoint of automotive sector fundamentals and deflation, the story is obviously much more complex.

On the one hand, the auto sector has been in a dis-inflationary period for some time after factoring in incentives and apples-to-apples options packages on vehicles. Auto affordability is at all-time highs as a result. Downward pressure comes from structural overcapacity but also from the unit cost competitiveness across companies, that is in turn taking down prices all along the production chain. The weak dollar might take some of this heat off, but by and large it is here to stay, since some the pressure to compete on price is tied to US-based transplants which face less of the currency risks than the rising wave of imports. There are still some offsets along the chain as the automakers take costs out of the system and they do not absorb the full impact from price pressures as a result. For example, suppliers have been facing 2% to 3% unit price declines annually in some cases, and the swing factor is a mix of production techniques, material costs, and perhaps in years ahead wages and benefits. That last part is obviously the most contentious, and that sets the stage for labor tension. If the scenario going forward really is for dis-inflationary pressure to turn into a broad decline in prices, then autos (with their high fixed costs) are clearly still vulnerable especially as we head into the UAW negotiations this fall.

The pressure in autos is mild, however, compared to the more notable freefalling sectors of 2002, especially along the tech and telecom chain as well as in power. Interestingly enough, those sectors have been relatively strong performers in 2003 and telecom is actually tighter overall thus far in May. **After the carnage in 2001-2002, the telecom sectors that are still investment grade may be perceived as more battle-tested in the current environment.** Indeed, if deflation

is a primary concern for this year then telecom, power and tech are three sectors of the market that already have experienced strong asset price deflation. That may have largely been attributable to forced selling of assets to deleverage and no logical buyers, but at least some of it is tied to a total lack of pricing power that may be more than just a near term cyclical correction. In telecom, bundled packages with fixed payments, stagnant and declining revenue stats on soaring usage, and the advent of fixed price, unlimited usage packages are all signs of the deflation risk. **Tech names also evidence some of the worst capacity utilization stats in the corporate universe**, and that translates into no pricing power or negative pricing trends until such time as the capacity-demand balance moves the right way. **In our view, the techs in the corporate universe have generally run too far too fast and will be market performers at best going forward.** While there are no pure power names left in high grade, the fallen angels are having a great run in the high yield market as they continue to print collateralized deals or shed assets to shore up liquidity. **We expect that the period of recovery from the merchant trading**

and Enron-style "asset-lite" period will allow power to stem the deflationary spiral more quickly than telecom and tech, but that still will be a slow process without more natural buyers surfacing beyond the financial buyers who have stepped in.

Since the beginning of 2001 there has been a strong relationship between the dollar and equity markets since both markets have functioned as a proxy for the perceived strength of the U.S. economy vis-à-vis the rest of the world. Since April, however, the relationship between equities and the dollar has broken down sharply with the dollar signaling that the conventional wisdom of a strong second half rebound in economic growth is questionable while equities have continued to price in a rebound in profits. Looking at the fundamentals and the persistent weakness in U.S. manufacturing and the labor market, we find the move in the dollar far more logical. While we'll likely get a pop in confidence with today's reading, it will be interesting to look at the composition of the survey to see where that optimism is coming from. There should be a positive effect from the continued rally in equities, but if we're right about that prospect for stocks, the rise in confidence could be fleeting.

In addition, we believe that the dollar could weaken even further in coming months. As we discussed yesterday in [How High Can it Go?](#) there are few instances when a market doesn't overshoot and right now there is a lot of momentum behind the weaker dollar trade. U.S. Treasury Secretary Snow has explicitly abandoned the decades old strong-dollar policy and seems content to allow the currency to weaken. Given minimal risk of importing global inflation the hope appears to be that an improvement in export competitiveness will help pull the U.S. economy out of its stupor. We agree that the risk of imported inflation is minimal given the still strong global dis-inflationary forces still at work, but somehow after 525 bp of Fed cuts and coming up on our second big fiscal stimulus package, the idea of exporting our way to recovery seems remote. Indeed we wonder whether Snow hasn't just increased the possibility of an accidentâ€defined here as a much more rapid collapse of the U.S. current account deficitâ€by essentially daring the market to test how far the G-8 is prepared to let the dollar slide.

One of the underpinnings of U.S. growth in the past decade has been the ability to attract foreign savings to cover the huge gap between domestic savings and investment (the current account deficit). With the dollar continuing to slide, interest rates in the U.S. at 40-year lows (and below those that prevail in the Eurozone), a rising fiscal deficit and a stock market that looks extremely topy, we wonder who is going to step up. We suspect that the answer may not come from abroad, but domestically as consumers look to shore up their balance sheets in the face of domestic economic uncertainty and still-high geo-political risk. **If that turns out to be the case then bond bulls should take heart â€ we are headed for a much slower recovery.**

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