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Big Investors Fear Deflation

Bill Gross Among Those Bracing for Possible Decline in Prices: 'It's Happening'

By GREGORY ZUCKERMAN

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Some of the world's leading investors are becoming more worried about deflation and re-shaping portfolios to prepare for a possible period of falling prices. Rick Brooks and David Weidner discuss. Also, August is a good month for stocks. Mark Hulbert tells you how to prepare.

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Editors' Deep Dive: Uncertainty Dims Hopes of Recovery

Bond-fund heavyweight Bill Gross, investment manager Jeremy Grantham and hedge-fund managers David Tepper and Alan Fournier are among the best-known investors who are bracing for a possible bout of deflation, a development that could cripple global economies and world stock markets.

The investors cite weak economic figures and a mounting consensus that global policy makers are reluctant, or unable, to take further steps to boost economic growth as reasons for their market positions.

"Deflation isn't just a topic of intellectual curiosity, it's happening," says Mr. Gross, who runs the \$239 billion mutual fund Pimco Total Return Fund, citing an annualized 0.1% decline over the past two years in the U.S. consumer-price index. "It's an uncertain world that's tipping toward deflation."

These investors are walking a fine line. Deflation scares immediately following the 2008 financial crisis didn't materialize, in large part because central banks intervened.

Indeed, many of these star investors don't see extended deflation as a sure bet and predict that, as deflation becomes more likely, the Federal Reserve and other government officials

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will take radical steps to arrest the decline, such as buying bonds or introducing spending programs.

Still, preliminary signs of deflation are spurring Mr. Gross and the others to take on larger positions of interest-bearing investments such as bonds or dividend-paying stocks. They also have begun buying protection against possible stock-market losses. In a period of falling prices,

companies can find it challenging to generate profits, putting pressure on stocks.

Recent data are responsible for the worries. The consumer-price index rose 1.1% in June compared with a year earlier. Friday's report on second-quarter gross domestic product showed the underlying inflation rate—which excludes volatile moves in food and energy prices and is closely watched by the Fed—increased 1.1%, the lowest reading since the first quarter of 2009. St. Louis Fed President James Bullard last week warned of a Japan-like period of deflation and slow growth.



Bloomberg News

WATCH FOR FALLING PRICES: A retailer knocks 40% off items in Washington, D.C., last Friday. The specter of deflation—broader declines in prices—has some noted investors adjusting their portfolios.

Such mainstream talk about deflation is a sharp reversal from just two months ago, when inflation, not deflation, was the focus of traders. Investors such as John Paulson, renowned for his bets against the U.S. housing market, piled on gold positions while others dumped U.S. Treasuries.

Mr. Gross has been aggressively buying U.S. government debt in recent weeks. Treasuries now account for about 51% of the portfolio of his Pimco Total Return fund, up from less than 33% at the end of March. It is as high an allocation to government securities for the fund as at any time in the past six years, according to

Morningstar Inc. The fund has risen 7% this year.

Mr. Tepper, who runs the \$15 billion hedge fund Appaloosa Management LP, has about 70% of his portfolio in bonds rated "BB" and "BBB"—the lowest end of the investment-grade spectrum and the upper tier of "junk"—from banks and others. That is up from 63% earlier in the year, investors say, helping him score gains of about 12% in 2010. He is sticking with credits that promise generous yields but still are relatively safe bets in any period of weak growth and potential deflation. "I'm concerned that slower growth may lead to a much tougher environment for pricing," Mr. Tepper says. "That can mean deflation in some industries, even if we get inflation in the overall economy."

Others, including the \$42 billion [Fortress Investment Group](#) LLC, the \$1.2 billion New York hedge fund Argonaut Capital Management and the \$107 billion Boston investment firm GMO LLC, founded by Mr. Grantham, are warning clients about possible deflation.

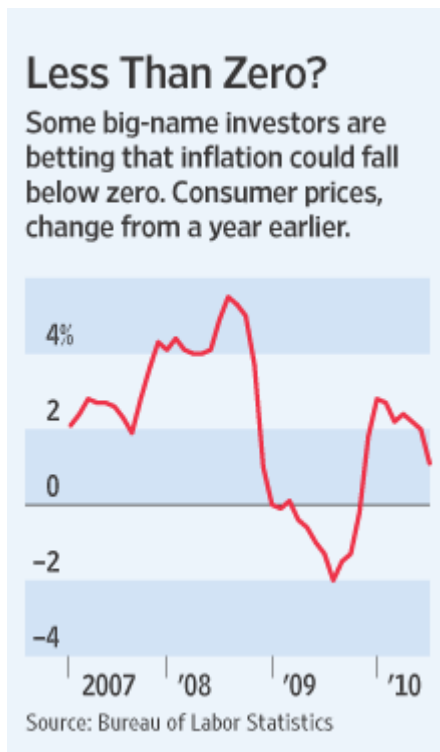
Deflation is seen as pernicious and hard to address once it sets in. Falling prices can make businesses and consumers reluctant to spend and invest, hurting profits and crippling the economy. It can be caused by a drop in the money supply and credit, declining spending and high unemployment, all of which can encourage companies to cut prices.

"We fear that core inflation readings in the United States could dip into outright deflationary territory in coming months," Argonaut Capital, whose returns are flat for the year, recently told investors. "This should be a positive for longer-dated fixed income."

Mr. Fournier's \$4 billion hedge fund Pennant Capital says "political winds shifted" when European nations recently told U.S. Treasury Secretary Timothy Geithner at the Group of 20 summit they will focus on balancing their budgets rather than stimulating economic growth. The rising clout of the Tea Party movement in the U.S. also has colored his view that elected officials won't have the ability to spend.

Mr. Fournier and some others say Tea Party adherents are appropriately worried about hefty government debts, but that without near-term spending and programs by elected officials, the economy could sink further.

"The U.S. economy has to grow north of 2% to avoid deflation, and we're right around there," he says.



Mr. Gross was much more skeptical of Treasuries as recently as about three months ago. Mr. Gross says he is paying particular attention to deterioration in an index produced by the Economic Cycle Research Institute that attempts to predict future economic health. In addition, he says, a drop in money supply and fiscal tightening in much of the world are reasons for Pimco's investment shift.

"We said, 'Hey, two-thirds of the world is moving to the zero line,'" of inflation, he says.

Pimco's team predicts "core" U.S. inflation, which excludes volatile energy and food prices, might drop a tad below 0% in the next few years; it could rise as high as 2% if economic growth improves.

There still is a big problem for investors preparing for deflation: It is hard to find attractive investments when it arises. Some say utilities and companies with stable cash flows are the best bets, along with government bonds. But many shares and riskier bonds depending

on rising corporate profits could be losers in such a scenario.

Mr. Gross urges investors to focus on cash flows that are "relatively certain," such as dividends and interest from stocks and bonds of quality companies.

Mr. Fournier is betting further economic difficulties spur politicians and the Fed to take aggressive actions to stave off deflation. But stocks may have to fall sharply before that happens; he is buying protection such as exchange traded funds that rise when the market falls. Argonaut founder David Gerstenhaber also is avoiding stocks, though he says the dollar could do well if deflation arises, as all kinds of borrowers slash debt. In a period of deflation, each dollar of debt becomes more onerous as wages and prices fall, as opposed to in an inflationary period, when the value of debt drops.

Deflation is no sure thing, the investors say. Mr. Tepper says that if the U.S. economy expands 1% or so over in the next few years, deflation and troubles for stocks will arise. Growth of 3% would boost profits and stocks, he says. At Pimco, Mohamed El-Erian, the firm's chief executive and co-chief investment officer, says "the risk of a deflationary spiral has increased, but it is still not the most likely scenario."

He says investors need to prepare for an unusually wide range of possibilities. The risk of so-called fat tails—or extreme outcomes—including a bout of prolonged deflation, are "not insignificant."

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