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Anil Rego

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Deflation: Impact on the `Aam` admi



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Author: Anil Rego

From a sizzling 13 year high of around 12% to a pithy 32 year low of 0.44%, all this drama barely within a span of 9 months. The whole town went ballistic speaking about Inflation, some time back and now everybody is contemplating on possibility of deflation! If you are unsure how these macro-economic factors would affect you, here`s a quick rendezvous across the happenings and likely impact thereof.

Deflation: Balloon goes kaput!

In economics, Inflation and deflation are parameters which define the real value of money. Deflation is a sustained decrease in the general price level of goods and services. Deflation occurs when the inflation rate falls below 0%, resulting in an increase in the real value of money - a negative inflation rate. We are however, still in the stage of disinflation, wherein Inflation is still in positive, however, it continues to slowdown. Inflation reduces the real value of money over time; conversely, deflation increases the real value of money. Deflation is also linked with recessions and with the Great Depression.

Economy and Sentiment

Deflation also prevents monetary policy from stabilizing the economy because of a mechanism called the liquidity trap. A recent report from CLSA stated that Indian economy could see a growth rate of 4.6%, another sign of slowdown in the economy. Deflation propels price falls across food commodities, since the price of goods is falling; consumers tend to delay purchases until prices fall further. This, in turn, leads to lower production, which causes lower wages and demand, leading to further decreases in prices. This is

called the deflationary spiral, or vicious cycle even when interest rates drop close to zero, it doesn't really help.

Our View- Is it a cause of concern?

Sustained deflation can be a great cause of concern. Sustained deflation is seen around the worst periods of depression. It shows that the consumer has lost the confidence to buy. Our view is that a key reason for deflation is the base effect. Inflation last year saw a sudden spike. Since inflation is calculated relative to the previous year, a higher base could temporarily result in deflation. The risk still remains though that continued deflation would be a real cause of concern.

Impact on Stocks/Sectors

Deflation could lead to lower interest rates and this can give some respite to industry. Sectors that are very dependent on capital like real estate, infrastructure and capital goods would be major beneficiaries. Lower interest rates could also result in higher real estate purchases as EMIs become more affordable. However the impact will not be immediate, but will be over 6-18 months.

Other avenue to invest- Income Funds

Deflation directly impacts interest rates, there could be further fall in Interest rates, loans could get cheaper, and however, simultaneously fixed income instruments can lose sheen over the next few months. But there still is one instrument which continues to stay attractive, `Income Funds` - they necessarily share an inverse relationship with interest rates. Falling interest rates are favorable for income funds and hence, they are likely to do well within a short term perspective. In fact, these funds have already proved to be the most fruitful investments over the past period -

Returns (%)

Fund Name	6-Month	1-Year
Canara Robeco Income	13.04	28.52
Reliance Income	12.24	13.2

Source : Myiris

Lower interest rates on home loans

Many of us can now heave a sigh of relief as interest rates are likely to fall on our home loans. If you are purchasing a house go in for a floating rate home loan. Interest rates on home loans are likely to head further south. Once it has fallen to a comfortable level, one can then look at converting it to a fixed rate loan.

Take deflation in your stride and benefit from the upsides.

Anil Rego is the founder and CEO of Right Horizons, an Investment Advisory and Wealth Management Company. Right Horizons has successfully practiced a de-risked

model with a Contrarian approach.

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