Market *Alert*

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STANDARD & POOR'S

The Lowdown on Deflation

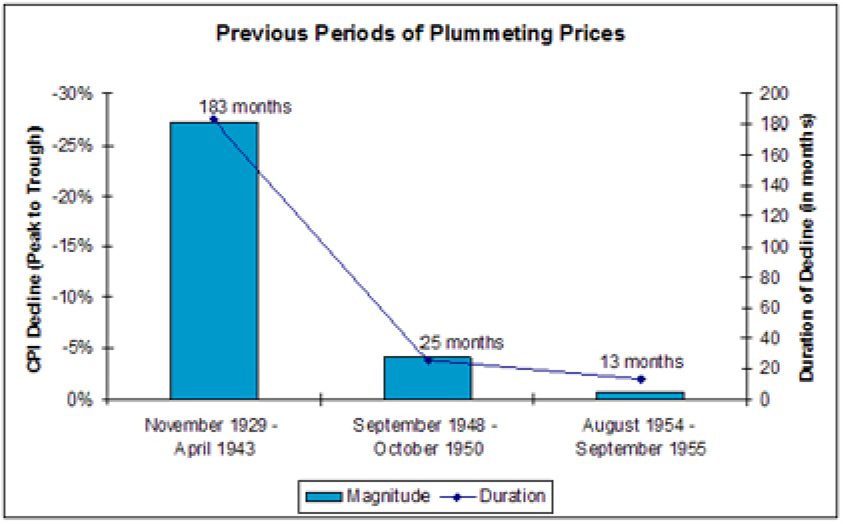
If a widespread, prolonged decline in prices does eventually emerge, the Federal Reserve has a number of policy options to provide financial stimulation.

Sustained deflation hasn't been a feature of the U.S. economic landscape in more than half a century. Yet anxiety about the prospect of falling prices has become one of the key concerns hanging over investment and business markets in 2010 -- particularly among those who worry that the economy could experience a "double dip" prior to making a full recovery.

Deflation Defined

Deflation is a widespread, prolonged decline in consumer prices. While that may not initially sound like a nightmare scenario to cash-strapped Americans, the onset of a deflationary environment could create a ripple effect of complex and deep-rooted financial troubles. Here's why.

When consumers slow their pace of spending (as in a recession), the volume of business falls. In response, companies adjust their activities with cutbacks of some sort, creating the ordinary ebb and flow of the business cycle. But sometimes, short-term adjustment strategies fail to maintain necessary business volume. Then, limited promotional sales discounts can become permanent and broad-based price cuts. One round of cuts like this scattered around the economy could also be seen as a normal part of a business cycle. But if consumers come to believe that prices may fall even more tomorrow, they could reduce their spending further today in anticipation. That expectation could set off a deflationary spiral of ever-lower spending and ever-shrinking prices. In the worst case, the result could be a long-term contraction of business activity marked by lower overall spending, reduced hiring, and shrinking wages.



Facts and Future Outlooks

At this point, deflation remains a possibility, but not yet a reality. But if a widespread, prolonged decline in prices does eventually emerge, the Federal Reserve has a number of policy options to provide financial stimulation. Officials could pump money directly into the economy by purchasing long-term bonds in the open market. They could also make certain interest rates effectively negative in wholesale markets, providing incentives for commercial banks to ease their credit policies and make more money in available that way.

Takeaways for Investors and Consumers

- A protracted period of stable or falling prices is likely to mean a similar period of very low long-term interest rates in the bond market. If long-term bond rates trend downward from their current levels, existing bonds with higher interest coupons could tend to become more valuable. That could boost total returns for those investors who hold those long-term bonds now.

- Consumers who owe money, on the other hand, could find that those obligations became even more burdensome if deflation caused their incomes to fall. The value of their liabilities would remain unchanged, but they would have less money with which to pay off those debts.

- There would be a similar issue for companies that had high levels of debt on their balance sheets. Highly leveraged companies could be expected to perform more poorly than firms with relatively little debt when all other factors are considered equal.

- Cash may also be an appropriate asset, even at low rates. If, for example, a savings account pays no interest but prices fall 2%, the money in the account will buy 2% more. That would give you an effective return of 2%, tax free.

Keep in mind that making radical changes to your portfolio on the assumption that inflation is imminent may be counterproductive. Instead, maintaining a well-balanced asset allocation that complements your long-term goals and risk tolerance may be more prudent.