Inflation And Me

With apologies to Buffalo Springfield...

There's something happening here
And what it is ain't exactly clear
There's a man with some bonds over there
Telling me I've got to beware

I think it's time we stop, traders, look around
Is deflation coming 'round?

There are battle lines being drawn
Gold's not right if the yield curve is wrong
P/E's are speaking their minds
Leaving so many values far behind

One of the drawbacks to being an aging Baby Boomer (listen up, young Boomees) is the unpleasant memory of inflation. This scourge, this cruelest tax of all, ignited during the mid-1960s when Lyndon Johnson tried to fight a war with ill-defined objectives and simultaneously engage in massive government spending without raising taxes to show the populace the costs of these actions. So, how did this Texan in the White House finance all of this? He prevailed upon then-longtime Fed Chairman William McChesney Martin to maintain an accommodative monetary stance.

We're so lucky no parallels exist today.

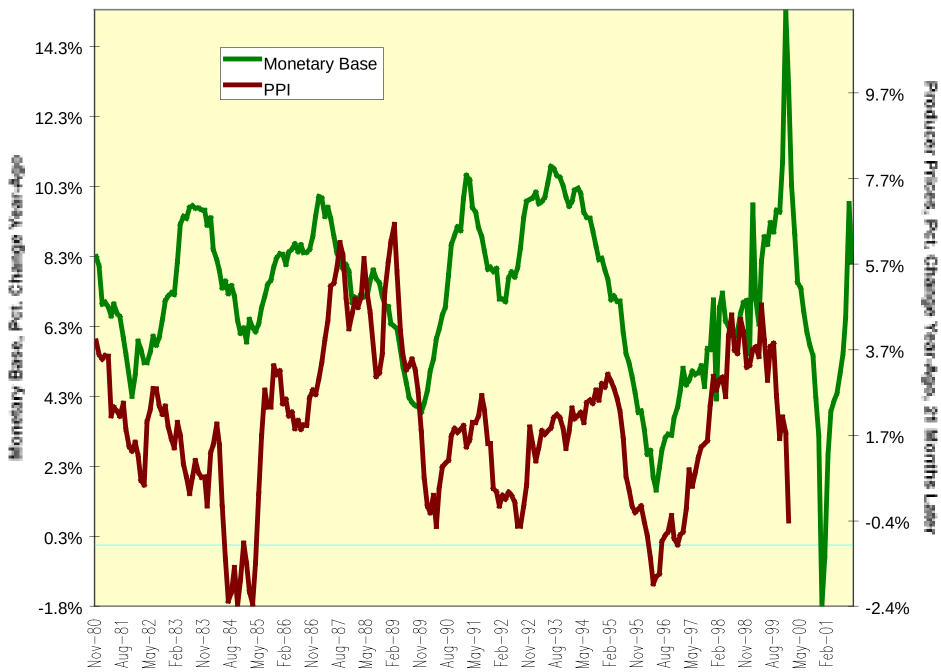
We're so unlucky, however, that textbook relationships between monetary policy, price levels, and financial markets have entered a new and dangerous phase. Let's untangle the mess a little and see what is implied for investing. You'll be surprised and pleased; it's my first remotely bullish analysis of 2001.

Can Monetary Ease Accompany Deflation?
Last week's stunning drop in the producer price index, the largest on record, helped revive discussion of whether we are in an epoch of systemic deflation, or falling prices. Readers who want to learn more on this subject should check out A. Gary Shilling's outstanding 1998 book *Deflation*, which may have been written three years too early.

Those who say deflation cannot persist in the face of expansionist monetary policies have the burden of proof. We only need cite the ongoing Japanese debacle or, for that matter, the U.S. during the 1930s. Money needs to be translated into credit to ignite inflation, and it's hard to expand credit in the face of (correctly) risk-averse bank lending policies, excess production capacity, and a continued flight away from lower grade corporate bonds in favor of Treasuries.

Let's look at the monetary base, the total amount of money in circulation plus reserve deposits at central banks (see "Remember The Money Supply," April 5, 2001). As monetarist theory would suggest, an increase in the monetary base should lead to an increase in nominal price levels at some point down the road. Over the 1981-1999 period, the lead-time between year-over-year increases in the monetary base and year-over-year changes in the producer price index was 21 months.

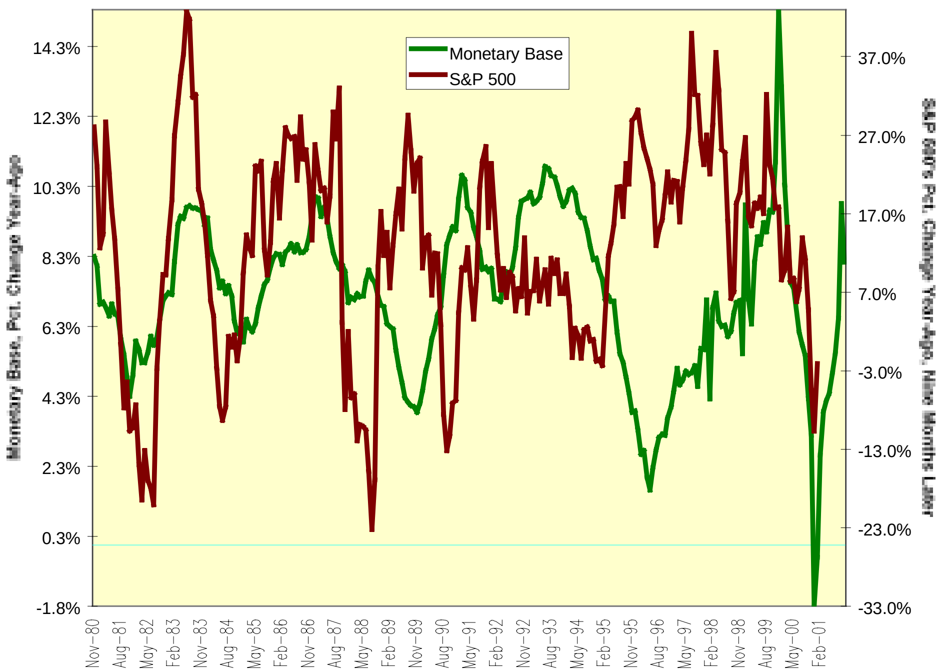
Does Base Set The Pace? If So, There's Deflation Ahead



But, we have an incredible reversal of pattern going on right now. Twenty-one months ago, the monetary base was expanding at double-digit rates as the tech boom was at its height and the Fed was printing money in anticipation of Y2K problems. Today the PPI is falling like a rock. Moreover, the period of maximum monetary creation was followed by a period of rapid decline in the base's growth rate. This suggests that we will be under some pressure on the price front for a while.

If the Fed is trying to inflate the stock market, which they'll deny from now until the end of time, they may have some short-lived success. In another interesting leading relationship, changes in the monetary base's year-over-year growth have affected the year-over-year rate of change in the S&P 500 nine months later. In other words, an early burst of money flows into financial assets before it flows into real assets, but this effect is soon seen for the illusion it is. The resulting pattern is an inverse relationship between money and equities with this lead time.

Monetary Base And Subsequent Changes In S&P 500

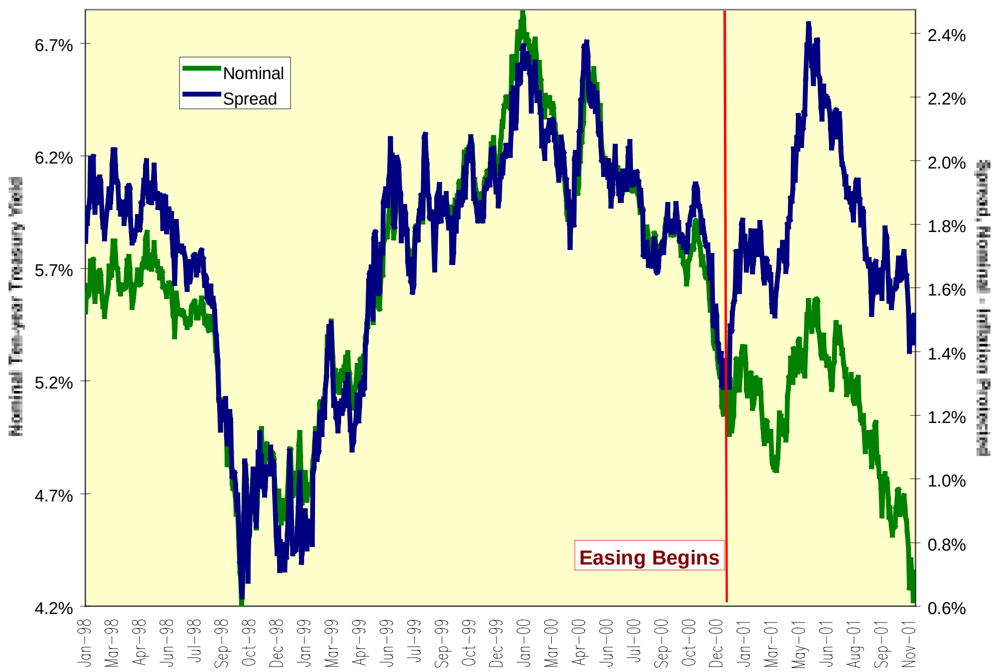


Don't Break The Thermometer

The Treasury's recent decision to abandon the long bond and inflation-protected securities (TIPS, see "Why It's Time To Fear Inflation, Feb. 23, 2001) based thereon was bad fiscal policy. It bad for market analysts, too, as it will eliminate a good source of information on inflation inferences from the yield curve and from the yield spread between the bond and its TIPS. The inflationary spread between the ten-year note and its TIPS, which surged between January and the peak of the spring stock market rally in May on the belief that this money would be translated into credit by banks, has continued to erode.

However, this inflation premium has not eroded as quickly as the yield on the Ten-year note itself, which suggests a divergence. Either nominal yields have fallen too low in our present flight-to-quality, or the bond market is in a state of disbelief on the strength of deflationary pressures. Given the breakdown in the monetary base / PPI relationship noted above, I'm going to go with the latter, which means that Treasuries may still be attractive even with the present positively-sloped yield curve and government stimulus festival.

Is Inflation Premium Still Too High?



Rational Overvaluation?
A lot has been made, and rightfully so, of the post-September 11th rally. Are we simply re-inflating the bubble? If we take the consensus forward-looking earnings estimate for the S&P 500 of $47.06 per share, we get a forward-looking P/E or 23.8; this translates to a bond-equivalent E/P of 4.2%. The ten-year note yield at present is 4.301%. Since stocks pay dividends; the present yield on the S&P 500 is 1.39%, and unlike fixed-income instruments, stocks' earnings can grow over time, it's not too much of a stretch to proclaim stocks to be fairly valued at present levels.

If we take a standard dividend growth model, and plug in the above numbers, we get a dividend payout of $15.57 per share on the S&P 500, 1.39% * 1120. Solving for the dividend growth rate, *g*, in the model below:

$$Index = \sum_{t=1}^{10} \frac{\$15.57}{(1+.04301-g)^{10}}$$

We arrive at an earnings growth rate of 8.45% over the next ten years. Over the past five years, actual earnings growth for the index, including our present unhappiness and a raft of global crises, has been 8.4%. This, folks, is doable.

Given the favorable inflation and interest rate outlooks noted above, only a collapse in expected earnings and a more severe economic downturn than foreseen at present should deter anyone from resuming an appropriate exposure to equities.