

Preparing For Energy-Driven Inflation

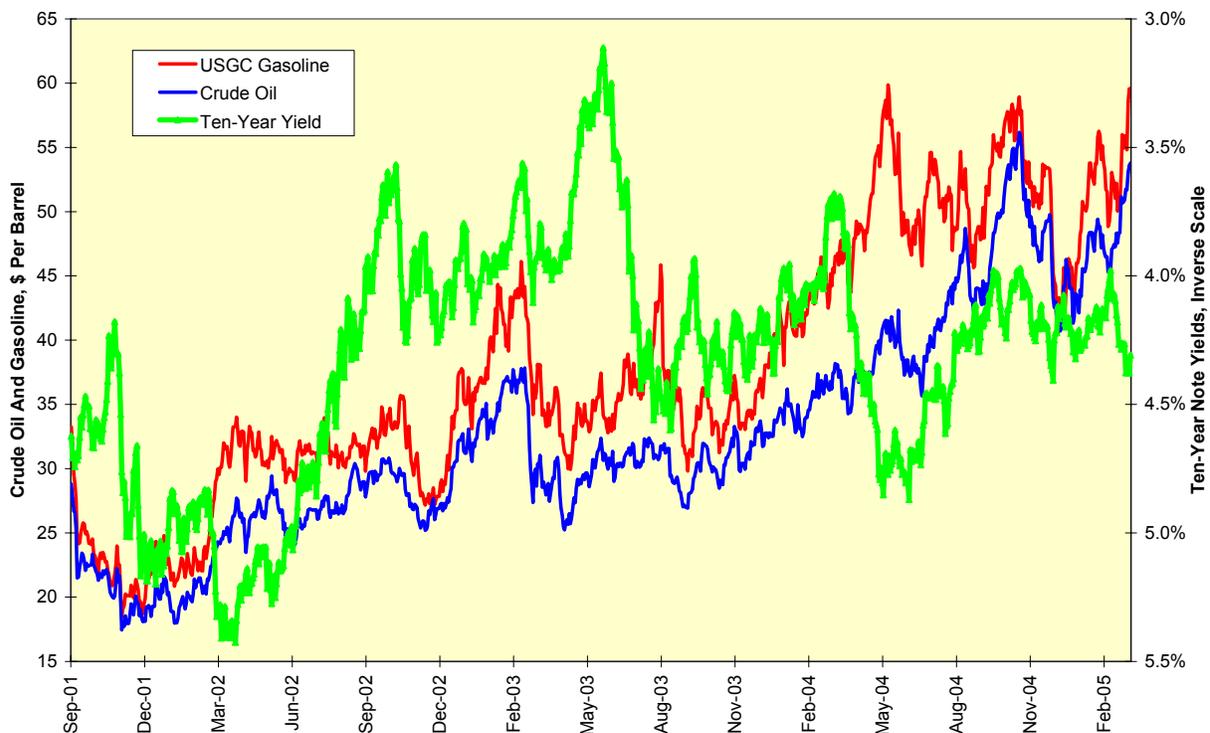
Who does not get a little nostalgic for 2004? Oh, for the good old days of swift boats and crude oil prices in the \$40s. Remember all that talk about how higher energy prices were driving bond yields lower because they were a tax on the economy?

Well, if they were a tax then, they must be a tax today. And if energy prices are headed higher now, as they certainly seem to be, should we expect the economy to slow under their weight and bond yields to resume their long-term decline toward Japanese-style levels?

Let's take a look at ten-year note yields plotted inversely to look like a bond price and the prices for both cash crude oil at Cushing, Oklahoma, and 87-octane gasoline at the U.S. Gulf Coast. We can see several distinct periods when yields fell along with rising energy prices: Dec. 2001-Feb. 2002, Jan.-Mar. 2003, Nov. 2003-Mar. 2004, Jun.-Sep. 2004, and Dec. 2004-Feb. 2005. Fans of seasonal analysis might note this wintertime confluence of higher bond and crude oil prices.

But we can pick through the chart and find numerous instances when higher rates and higher energy prices coincided, including the present. A simplistic conclusion that higher energy prices always leads to higher bond prices is unsupported in the data. Other factors are at work and must be accounted for in the analysis.

Energy Prices And Note Yields



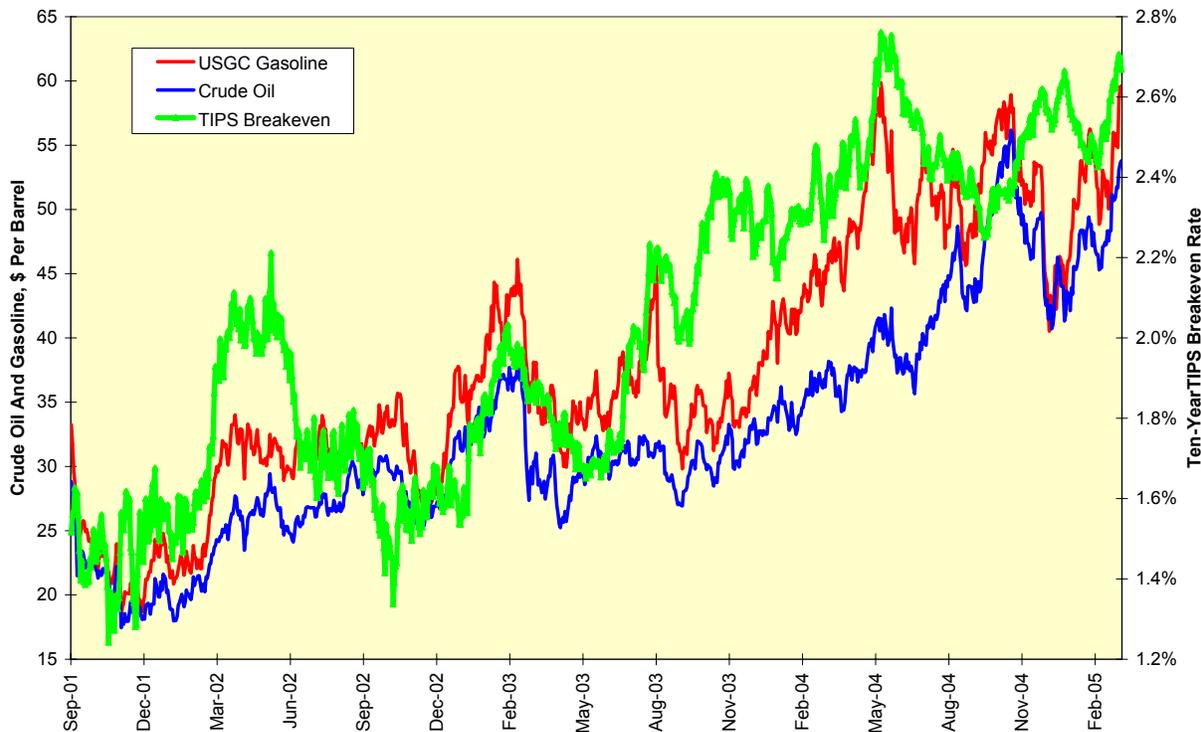
The Inflation Link

A second and equally important question is whether higher energy prices are consistent with higher levels of expected inflation. Please note how I said “consistent with” rather than “cause.” If you believe inflation is a monetary phenomenon - and I do - higher prices for any good cannot cause inflation, they can only redistribute your spending patterns. If, however, higher energy prices act as a tax and as a contributor to the U.S. current account deficit they should have the effect of lowering GDP growth and, in a Keynesian sense, reduce inflationary pressures.

If we map energy prices against the Ten-year TIPS breakeven rate of inflation, the difference in yield between regular Treasury notes and ten-year TIPS, we see a reasonably close correlation between this rate and gasoline prices until we get to 2004. Between June and September 2004, expected inflation fell by 50 basis points, from

2.75% to 2.25% per annum. Crude oil shot higher during this period, but gasoline did not, and it is gasoline whose presence is felt in the Consumer Price Index, the basis of TIPS pricing. You and I buy gasoline; only refiners buy crude oil. Last year's summertime divergence between crude oil and gasoline was unusual, to be sure. If gasoline prices move higher this year, inflation as measured by the CPI will increase perforce as motor fuels account for 3.25% of the CPI.

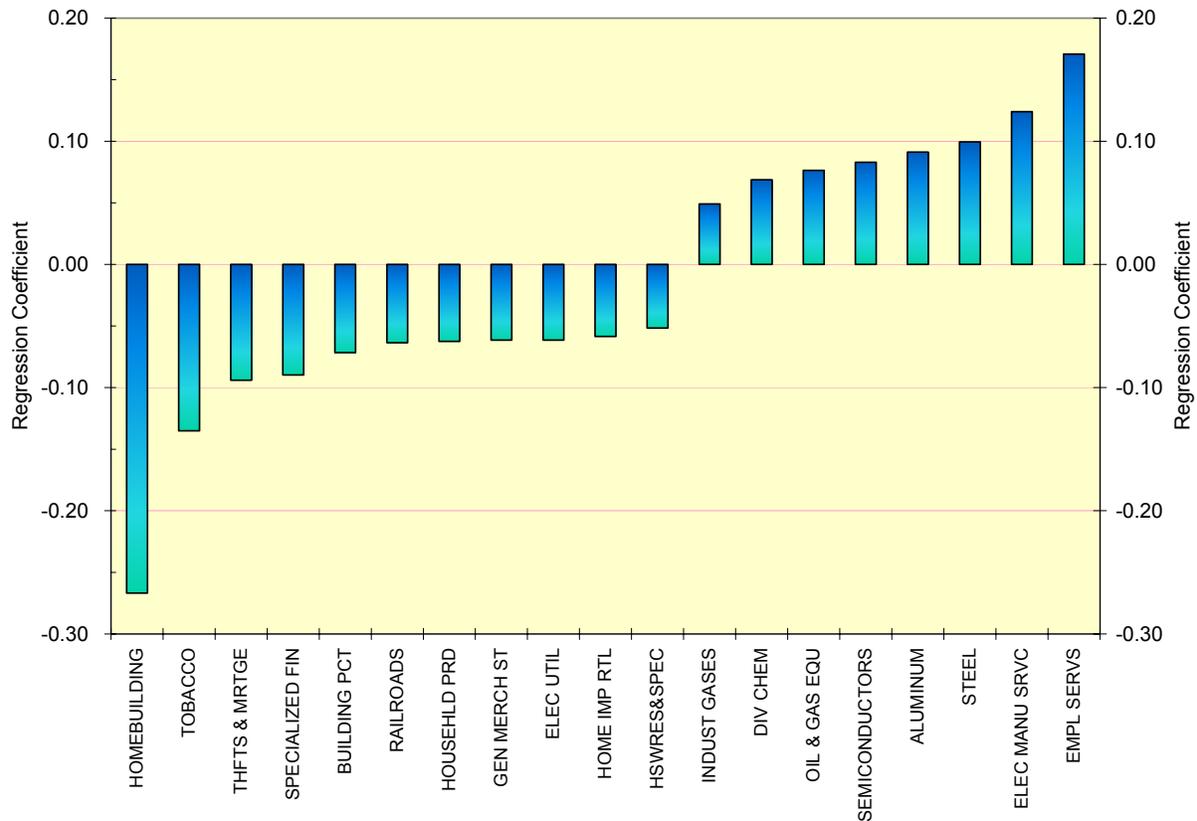
Energy Prices And Expected Inflation



Inflation's Stock Market Impact

Expected inflation has been on the rise since the beginning of February; indeed, it has been on a gradual rise since late 2002. Which industry groups within the S&P 500 are affected by the rise and fall in the TIPS breakeven rate? Let's return to the same analysis demonstrated here on [Feb. 8](#) for the impact of the euro and [last week](#) for the impact of both crude oil and copper on various S&P industry groups. The performance of each of the S&P 500's 113 industry groups relative to the index as a whole was regressed against, or explained statistically as a function of, the TIPS breakeven rate of inflation. Nineteen of the groups had a statistically significant beta, or relative volatility, against expected inflation.

S&P 500 Group Relative Performance:
Contribution Of The 10-Year TIPS Breakeven Rate Of Inflation

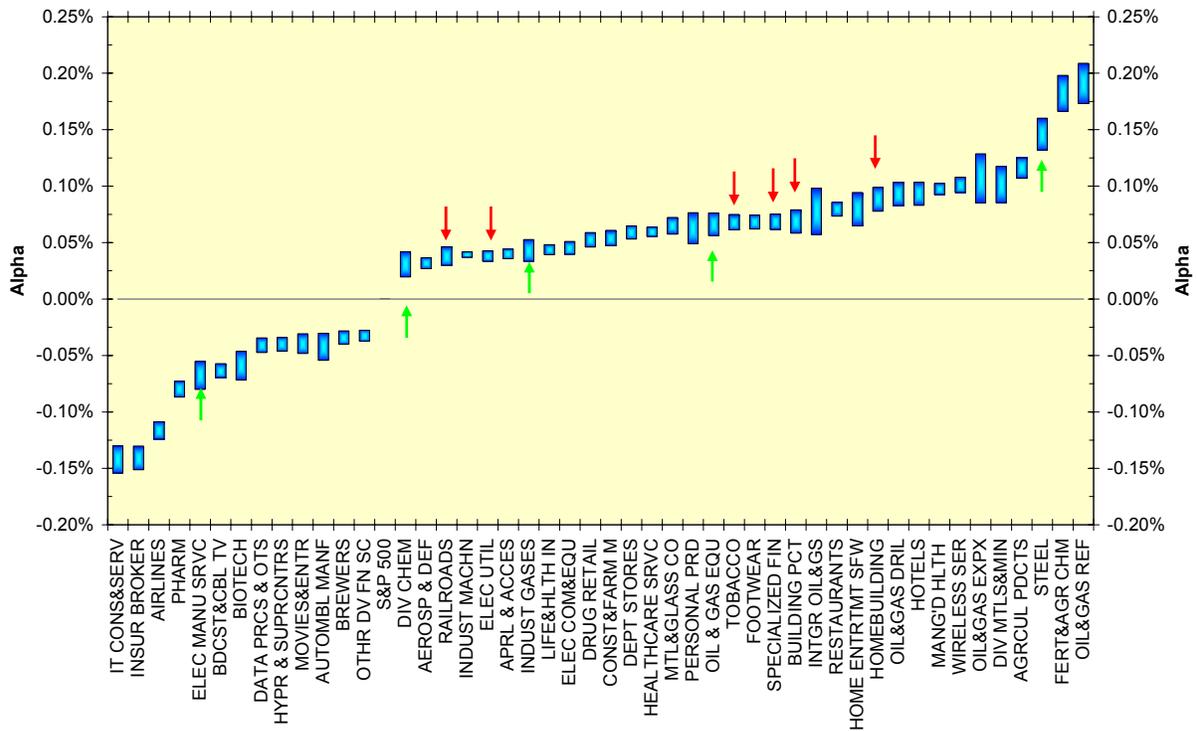


It might be disingenuous to ask which groups benefit from higher expected inflation; one of the lessons of the 1970s was a rising tide of inflation swamps all boats. It is the most insidious tax imposed on society. But enough of the soapbox: The Employment Services, Electrical Manufacturing Services, Aluminum, Steel, Semiconductor, Oil & Gas Equipment, Diversified Chemicals and Industrial Gases groups all rise *relative to the S&P 500* when expected inflation rises. Losers *relative to the S&P 500* include Homebuilding, Tobacco, Thrifts & Mortgages, Specialized Financial Services, Building Products, Railroads, Household Products, General Merchandise Stores, Electrical Utilities, Home Improvement Retailers and Housewares & Specialties.

If there is a general theme here, it is you want to be in the business of making heavy and capital equipment for a wholesale customer when expected inflation rises. You do not want to be in anything to do with residential construction, housing-related finance or discretionary retailing.

How have these tendencies squared against recent behavior in the market? As we did last week, let's map the statistically significant alpha, or expected over- or underperformance of groups relative to the S&P 500. The groups marked with downward-pointing red arrows are those with negative betas against the broad market; those marked with upward-pointing green arrows have positive betas against the broad market.

**Range of Statistically Significant Alpha By Group
Over Past Thirty Trading Days**



Six groups merit particular attention, the Railroads, Electric Utilities, Tobacco, Specialized Finance, Building Products and Homebuilders. Each of these groups has had positive alpha over the past thirty trading days. Each of them has a negative beta to higher expected inflation. Put the two together and the message is simple: If you think energy prices are going to rise and inflation will rise therewith, these groups' outperformance will come to an end soon.

On the opposite side, all of the groups marked in green, Electrical Manufacturing Services, Diversified Chemicals, Industrial Gases and Steel all should continue their strong relative performance.

What about the groups that led the pack last year, such as Fertilizers & Agricultural Chemicals or Internet Retailers. You have to be kidding – that's so 2004.