# Inflation Is Grey, Not Black Or White

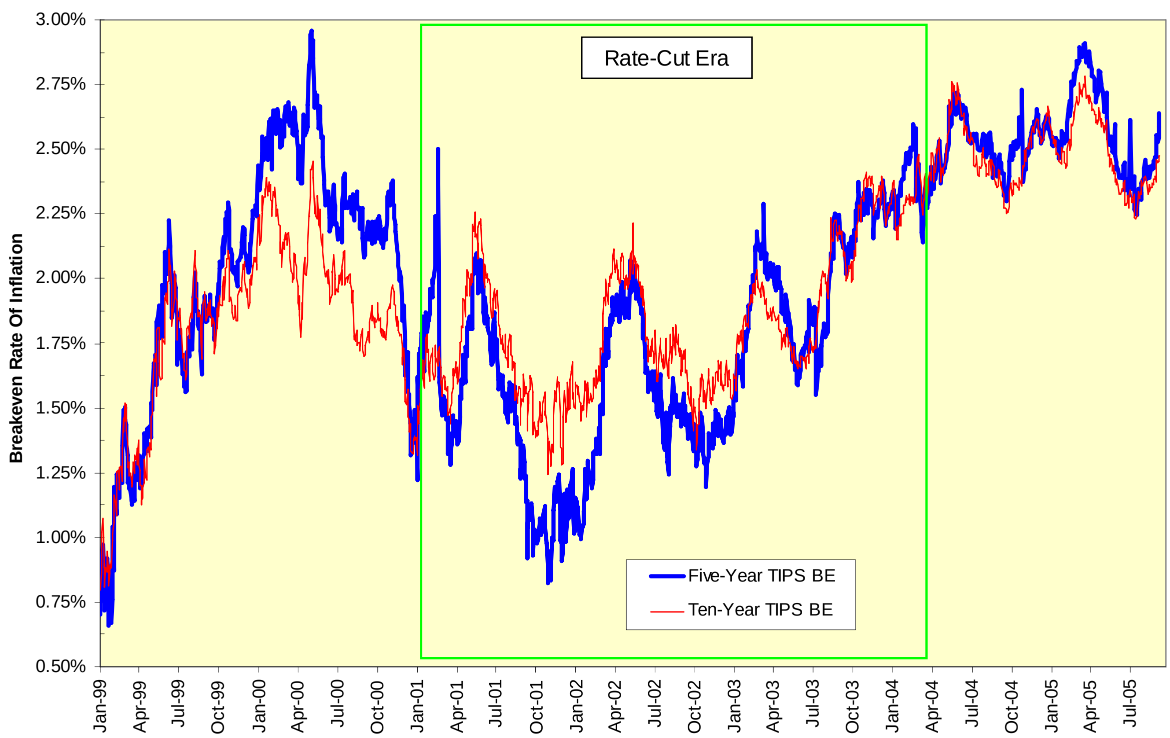
Ah, history! Those who forget its lessons are condemned to repeat it; those who learn its lessons misapply their knowledge. The inflation experiences of the 1970s, the original *Rocky Horror Picture Show*, have induced us to go down both paths of error in the quarter-century since. How ever shall we cease dancing the Time Warp again?

One of the very many market reactions to Hurricane Katrina, discussed here last week in the context of petroleum prices, has been speculation the Federal Reserve will back away from its near-stated path of 25 basis point increases in the federal funds rate at its September 20th meeting. The market assumed, not without reason, that such an action would weaken the dollar and increase inflationary pressures by virtue of excess monetary creation.

Let's do some history and place inflationary expectations in their broader context. The measure used for inflationary expectations (not reported inflation, as in the CPI) will be the difference between nominal yields and TIPS yields. The difference, ignoring the various options embedded in TIPS, is a breakeven rate of inflation that should make an investor indifferent between holding the two securities.

The history of these breakevens for both five-year and ten-year notes over the past six and one-half years shows a marked downtrend between April 2000, near the stock market's peak and November 2001, the aftermath of September 11th, and a steady uptrend from then until the April 2005. The era of rate-cutting is marked for those who wish to make a causal connection between inflation and monetary policy.

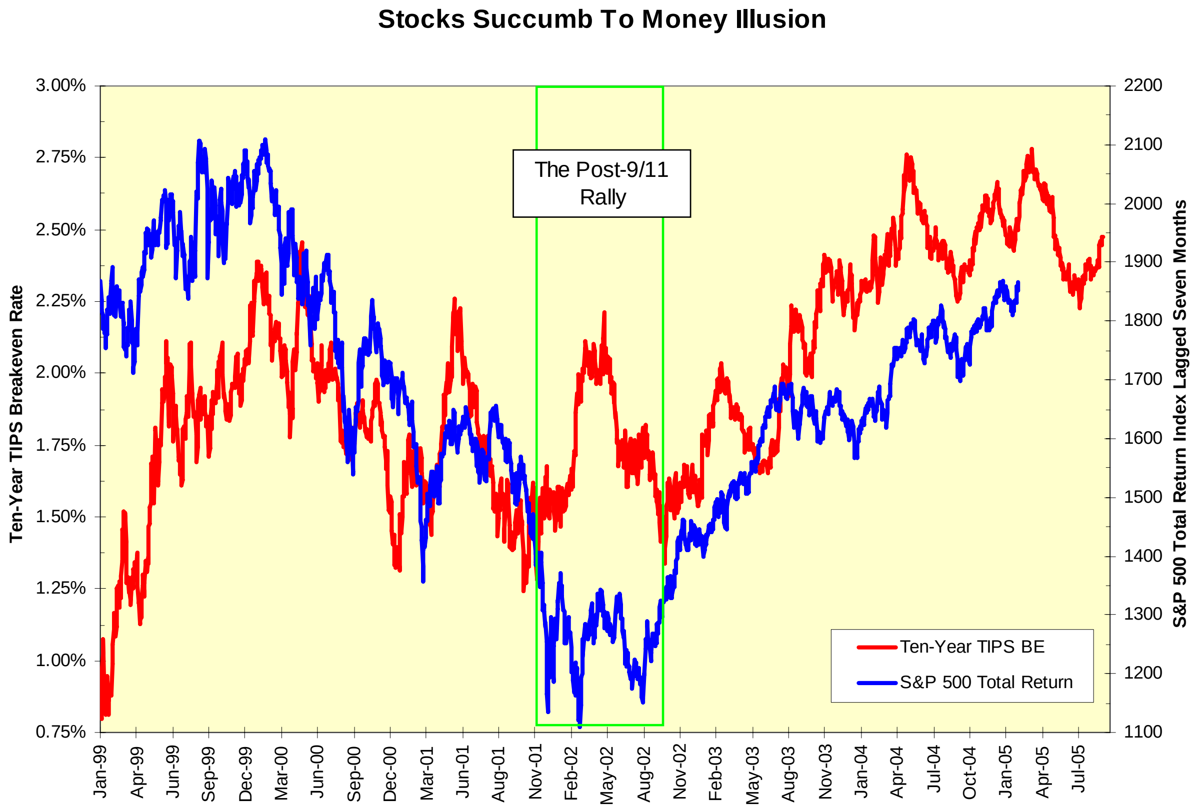
**Inflation Expectations Resume Their Uptrend**




If the chart above were a stock, would you buy it? We all are entitled to our opinions, but the picture looks bullish to me. If inflation is once again to be a scourge upon the land – and those of us who lived through the 1970s cannot regard it otherwise – what will the implications for the stock market be? The reaction to Katrina so far has been bullish on three counts:

1. The notion, arguably misplaced, that rebuilding the Gulf Coast will be a massive stimulus to the economy;
2. The notion, arguably inaccurate, that we have seen the highs for both petroleum and natural gas; and
3. The notion, arguably a triumph of hope over reality, that monetary policy will be relaxed

**Inflation And Stocks**
If the last of the three reasons offered above is the most compelling, and the market associates lower interest rates with higher inflation, shouldn't we all be exiting stocks in droves? No: The history of inflation breakevens is they lead the total return of the S&P 500 by seven months. This phenomenon is known as monetary illusion for the way people feel better about excess liquidity before realizing its consequences.

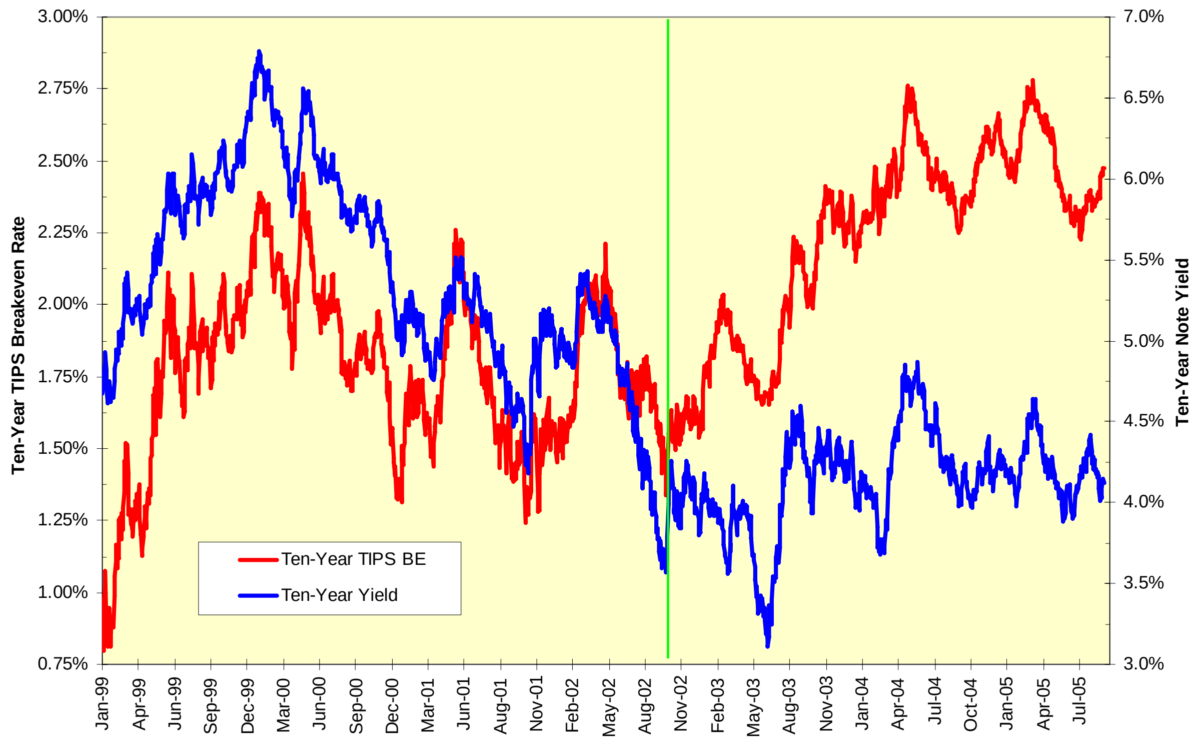



If history is to repeat itself, the upturn in inflationary expectations seen this March in the aftermath of the corporate bond selloff of the time, is still affecting the course of stocks today. The downturn in inflationary expectations between March and July 2005 normally would put downward pressure on stocks starting later this month – recall the September 20th FOMC date if you are into numerology – but this course could be derailed easily given the extraordinary impact of Katrina.

And exceptions do occur: The Federal Reserve's post-9/11 influx of liquidity, marked with a green rectangle, succeeded in producing both an increase in inflationary expectations and a short-lived rally in stocks, but money illusion can take a dying market only so far. Seven months after inflationary expectations peaked, stocks were at or near the bear market lows.

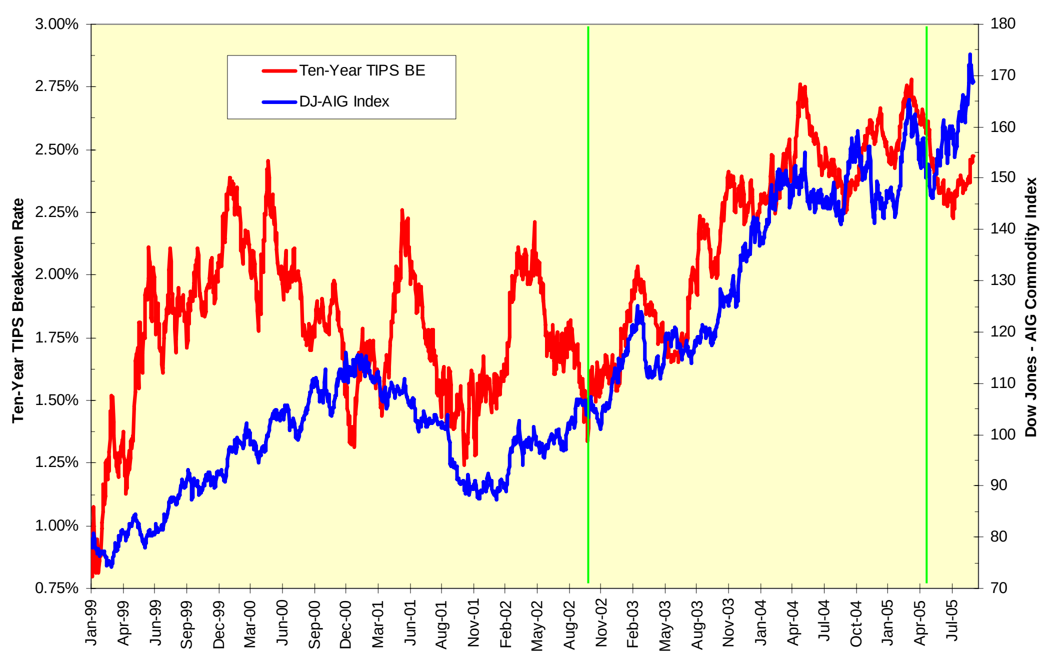
**Inflation, Commodities And Bonds**
Money illusion is somewhat understandable for stocks. Prior to the 1970s, common stocks were considered to be inflation hedges; the thinking went that corporate profits would rise along with the general price level. No such illusion ever applied to bonds, though, which makes the next bit of history even more mystifying. After the October 2002 bear market low, inflation expectations started to rise steadily. Nominal ten-year note yields have remained in a low and tight trading range. Implicit in all this is a steady decline in the real interest rate during a time of strong economic growth. This would be true only if the supply of funds available to buy bonds was increasing faster than the demand for credit, certainly a possibility given the massive Asian central bank bond purchases seen since that time.

## Ten-Year Note Yields Have Been Ignoring Inflation




Equally interesting is another piece of history, the relationship between inflation expectations and commodity prices as measured by the Dow Jones-AIG index. Prior to October 2002, these two series were unrelated; after that date inflation expectations tended to lead commodity prices higher in a closely correlated fashion until May 2005. Over the past four months, commodity prices rose much faster than inflation expectations, meaning higher commodity prices were not considered a harbinger of greater inflation.

## Commodities And Inflation Coupled After Bear Market Ended



### Investment Implications

Which stock groups benefit from rising inflationary expectations, and which are hurt thereby? Let's return to the industry group analysis introduced here in February to answer this question. The table below depicts, by S&P market index, the winners in black font and the losers in red font.

**Relative Industry Group Betas To Inflation Expectations**

| S&P 500 | | S&P 400 | | S&P 600 | |
|---|---|---|---|---|---|
| Group | Beta | Group | Beta | Group | Beta |
| HOMEBUILDING | (0.257) | HOMEBLDNG | (0.269) | HOMEBUILDING | (0.233) |
| TOBACCO | (0.127) | AUTO MANF | (0.116) | COMP&ELEC RETL | (0.176) |
| THFTS & MRTGE | (0.098) | HHOLD PROD | (0.104) | MOV & ENTR | (0.128) |
| SPECIALIZED FIN | (0.082) | CONST MAT | (0.088) | REIT | (0.086) |
| GEN MERCH ST | (0.077) | ADVER | (0.078) | HOME FRNSH | (0.076) |
| HOUSEHLD PRD | (0.059) | REITS | (0.077) | CNSTR & ENGN | (0.075) |
| BUILDING PCT | (0.057) | HLTHCR FAC | (0.069) | AGR PRD | (0.061) |
| HOME IMP RTL | (0.053) | REINSURNCE | (0.065) | THFT & MRTG FIN | (0.059) |
| ELEC UTIL | (0.052) | HOME FURNISH | (0.063) | ELEC UTIL | (0.037) |
| REAL EST INV | (0.051) | ELEC UTIL | (0.054) | REGNL BANKS | (0.024) |
| HSWRES&SPEC | (0.050) | DIST&VINT | (0.050) | | |
| CONSUMER FINANCE | (0.038) | RESTRNTS | (0.049) | | |
| | | IND PW PRD | (0.047) | | |
| | | PRP&CAS INS | (0.042) | | |
| LIFE&HLTH IN | 0.034 | PAPER PCKNG | 0.042 | ELEC EQ MFG | 0.043 |
| INTGR OIL&GS | 0.054 | ELE CMP&EQ | 0.047 | OFF SERV & SUPPL | 0.046 |
| FOREST PROD | 0.056 | AIR FR&LOG | 0.053 | BUILD PRD | 0.056 |
| ELEC MANU SRVC | 0.080 | AUTOP&EQP | 0.058 | ELEC MANU SRVC | 0.066 |
| DIV CHEM | 0.082 | DIV CHEM | 0.060 | OIL&GAS PROD | 0.075 |
| ALUMINUM | 0.104 | BIOTECH | 0.076 | EMPL SRVCS | 0.076 |
| INET SFT&SER | 0.107 | OIL&G DRIL | 0.086 | OIL&GAS EXPL | 0.077 |
| OIL & GAS EQU | 0.112 | CMDTY CHEM | 0.088 | COMMDT CHEM | 0.084 |
| INTERNET RET | 0.116 | OIL&G RFNG | 0.089 | MARINE | 0.091 |
| EMPL SERVS | 0.152 | EMPL SERV | 0.089 | DIVSFD METL | 0.092 |
| STEEL | 0.156 | TRUCKING | 0.104 | SEMICNDTR EQUIP | 0.094 |
| | | ELEC MANFCT SRV | 0.106 | INTRNT SFW & SRVCS | 0.101 |
| | | MARINE | 0.142 | ALUMIN | 0.124 |

The groups hurt include Homebuilding, Electric Utilities, REITs, consumer- and real estate-oriented financials and housing-related consumer products groups such as Housewares & Specialty Retailers, Household Products, Home Furnishings and Home Improvement Retail. The theme here is obvious: Higher inflation will do the housing sector, the engine of growth for the past two years, no good.

It must be emphasized that this is a *partial* effect, one derived while holding all other factors constant. The massive post-Katrina rebuilding of the Gulf Coast can overwhelm the negative effects of higher inflation on these groups.

Winners are in the Basic Materials sector and include Steel, Aluminum, Forest Products, Paper, Chemicals and Metals & Mining. The Energy sector is represented, as are Technology groups such as Internet Retailers, Internet Software and Semiconductor Equipment. Electrical Manufacturing Services, firms such as Sanmina, Molex, Jabil Circuit and Solectron, are represented in all market indices.

Looking for winners, short-term or long-term, if inflation does emerge as a threat is to ignore another lesson of history: You can live with inflation for a while, but not forever. And the cure – just ask Paul Volcker – can be as rough as the disease.