Inflation Expectations And Industry Group Performance

A Rising Inflation Tide Would Flatten All Boats

You might think that with all of the derision, scorn and opprobrium directed at Greece over the past two years someone would have taken the time to nominate their alphabet for a bashing or two. If nearly every market crisis of the past quarter-century can be traced back to people who excelled in mathematics while not excelling in humility (think Bankers Trust, Enron, Long Term Capital Management and, of course, anything related to mortgage derivatives) then experts familiar with Greek mathematical symbols for financial concepts are to blame.

Consider some prime examples of "The Greeks:"

1. α or alpha. This is the expected degree of market outperformance. Everyone claims to add alpha; few do
2. β or beta. This is relative volatility. Cowboy-stuff. Most high returns are attributable to excess risk, even though no one wants to admit it
3. δ or delta. This is the expected relative rate of change between two assets. Always looks nice on paper.
4. γ or gamma. This is the rate at which delta changes. Always surprises the folks who thought they had their risks managed
5. ψ or psi. This is the twenty-third letter in the Greek alphabet. Do psi's matter?
6. μ or mu. This is the average. As in Lake Wobegon, all managers are above average
7. σ or sigma. The standard deviation of returns, or measure of past risk. Also looks nice on paper; and
8. π or pi. Reserved for politicians.

Impact Of Inflation Expectations

I have looked at the performance of industry groups in the S&P 1500 relative to the index as a whole as a function of various market factors, included ten-year TIPS breakeven rates of inflation. The table below depicts those groups whose relative performance passes a 90% confidence interval and their net weighted beta, or product of their weights in the S&P 1500 multiplied by the factor beta.

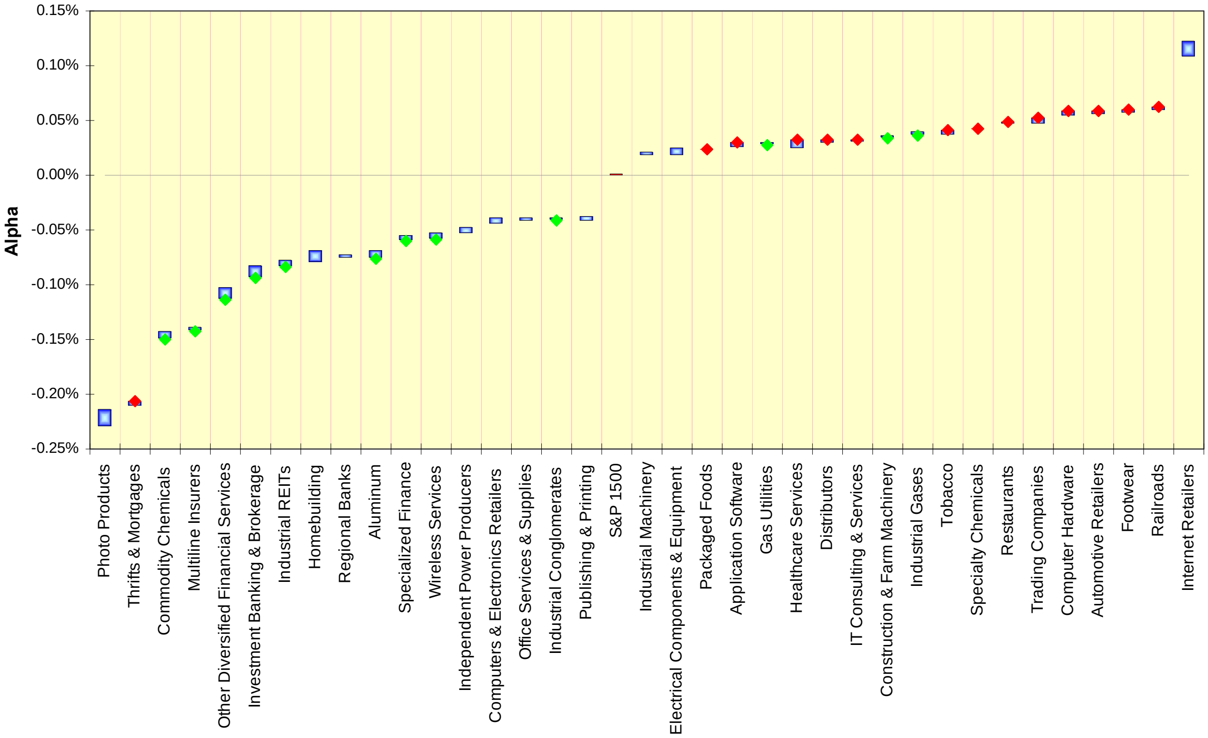
Ten-Year TIPS Breakeven Betas

	Weighted Beta		Weighted Beta
Pharmaceuticals	0.0001	Oil & Gas Exploration	0.0003
Integrated Telecommunications	0.0001	Oil & Gas Equipment	0.0002
Computer Hardware	0.0001	Integrated Oil & Gas	0.0002
IT Consulting & Services	0.0001	Life & Health Insurers	0.0001
Semiconductors	0.0001	Other Diversified Financial Services	0.0001
Household Products	0.0001	Industrial Conglomerates	0.0001
Hypercenters & Superstores	0.0001	Movies & Entertainment	0.0001
Communications Equipment	0.0001	Oil & Gas Refining	0.0000
Tobacco	0.0001	Oil & Gas Storage	0.0000
Aerospace & Defense	0.0001	Steel	0.0000
Packaged Foods	0.0001	Coal & Cons. Fuels	0.0000
Soft Drinks	0.0001	Specialized REITs	0.0000
Biotech	0.0001	Diversified Metals & Mining	0.0000
Drug Retailers	0.0000	Oil & Gas Drilling	0.0000
Internet Software & Services	0.0000	Multiline Insurers	0.0000
Application Software	0.0000	Broadcast & Cable TV	0.0000
General Merchandise Retailers	0.0000	Construction & Farm Machinery	0.0000
Electric Utilities	0.0000	Industrial Gases	0.0000
Railroads	0.0000	Diversified Chemicals	0.0000
Restaurants	0.0000	Investment Banking & Brokerage	0.0000
Automobile Manufacturers	0.0000	Consumer Finance	0.0000
Data Processing & Outsourcing	0.0000	Wireless Services	0.0000
Healthcare Services	0.0000	Specialized Finance	0.0000
Environmental Services	0.0000	Aluminum	0.0000
Department Stores	0.0000	Industrial REITs	0.0000
Distillers & Vintners	0.0000	Construction & Engineering	0.0000
Trading Companies	0.0000	Diversified REITs	0.0000
Footwear	0.0000	Gas Utilities	0.0000
Auto Parts & Equipment	0.0000	Electrical Manufacturing Services	0.0000
Food Distributors	0.0000	Healthcare Facilities	0.0000
Distributors	0.0000	Tires & Rubber	0.0000
Automotive Retailers	0.0000	Commercial Printers	0.0000
Office Electronics	0.0000	Reinsurance	0.0000
Thrifts & Mortgages	0.0000	Commodity Chemicals	0.0000
Specialty Chemicals	0.0000		
Home Improvement Retailers	0.0000		
Insurance Brokers	0.0000		
Leisure Products	0.0000		
Building Products	0.0000		
Brewers	0.0000		
Education Services	0.0000		
Metal & Glass Containers	0.0000		
Trucking	0.0000		
Home Entertainment Software	0.0000		
Subtotal:	-0.15%	Subtotal:	0.17%
		Total:	**0.03%**

Unsurprisingly, many of the energy, basis materials and financial groups have a positive relationship with higher expected inflation; these are seen in the right-hand cells. The industry groups with a negative relationship are scattered all over the sector map, which sounds much worse than it is. The net impact is a near-zero 0.03%; each 1% increase in TIPS breakevens, just over 2 basis points at present, would be expected to lead to a 0.0003% increase in the S&P 1500, all else held equal.

So, is that the end of it? Hardly; if I isolate the groups with statistically significant alpha over the past thirty trading days (the height of the blue column is the alpha's range) and overlay their betas to TIPS breakevens, an interesting pattern emerges. The negative betas, marked in red, are clustered in the positive alpha groups, and the positive betas, marked in green, are clustered in the negative alpha groups.

Industry Groups With Statistically Significant α: β To Ten-Year TIPS Breakevens



The conclusion is simple: If inflation expectations rise, the outperformance of the strong groups will fall and the underperformance of the weak groups will narrow. The opposite should be true as well. Even if the overall impact of inflation is minor, the industry group pattern could be significant.