TrendMacrolytics

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MACROCOSM

Gold $400

Wednesday, November 19, 2003

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400 is just a number. Gold is just a barbarous relic. And Helen of Troy was just a woman.

The most monetary of commodities -- gold -- is telling us loud and clear that inflation is once again a factor in our lives. Gold itself may be only one indicator, and touching the $400 level overnight *per se* may only have symbolic significance. But gold is not alone. Other commodities prices are soaring, too. The dollar is dropping on foreign exchange markets. The spread between Treasury bonds and their inflation indexed counterparts (TIPS) is widening. The yield curve is steep, and would be even steeper if it weren't for **the Fed** jawboning if down. Even lagging statistical measures of inflation such as the Producer Price Index and the personal consumption expenditures deflator are turning higher.

The market has spoken: inflation is back. Yet the conventional wisdom insists that inflation is impossible now -- unthinkable! -- after five years of monetary deflation. Remember, though, when that deflation began in 1997 the conventional wisdom was that *it* was impossible, too. It has only been over the last year that the existence of that deflation has even been acknowledged by the central bank that caused it -- now that the deflation has, in fact, ceased to exist. Now, with the Fed seemingly flummoxed by the unprecedented challenge of managing its way out of a deflation that it said couldn't exist, we can't help but think of the scene in the sequel to *Jurassic Park* in which the mad scientist assures the hero, "Don't worry, I'm not making the same mistakes again." The hero replies, "No, you're making all new ones."

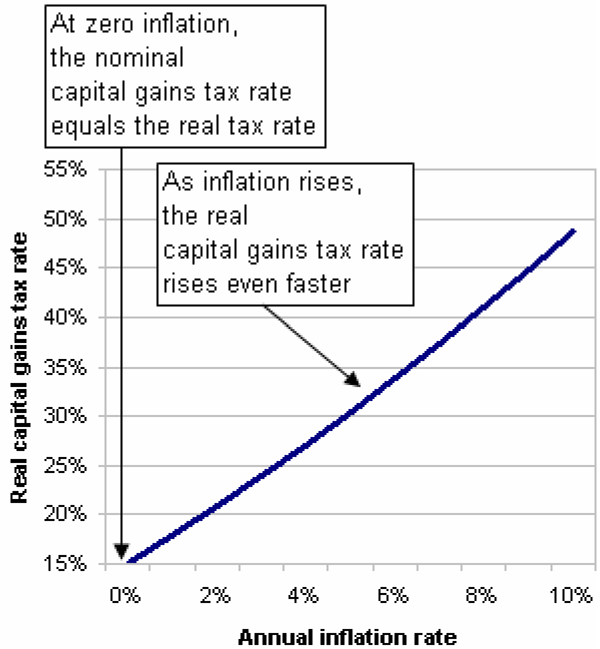
It's no longer a question of *if*. Some degree of inflationary mistake is now baked in the cake. Yes, if the Fed changes course soon, the effects can still be small and short-lived. But even as we hope for the best, we need to start asking ourselves how much inflation there will be, for how long, and how to invest in light of it. Those are complex issues, and we will have a lot to say about them over the coming months.

The one easy call here is Treasuries. With the Fed propping up the long end with the lure of the "carry trade," they are a bad accident waiting to happen. In fact, the accident has already begun to happen. Arbs who put on the carry trade in mid-June are already so severely underwater that they would have to hold their positions for two years now just to break even -- a "considerable period" indeed -- and *that's* assuming no further losses in their long bond positions. Sooner or later, mounting inflation premiums will put the Fed in a position where there is simply nothing more they can do to prop up the long end. If it comes to that, bond prices will collapse -- along with the Fed's credibility.

Corporates, on the other hand, need not take the full brunt of the inevitable rupture in Treasuries. The early stages of an inflation may well continue the credit-strengthening dynamics for corporates, especially non-investment grade, that have already been set in motion by the salutary reflation (as opposed to inflation) of the last 12 months.

For equities, the prospects are not so straightforward. It is too simple by half to blithely assume that nominal earnings growth will track inflation -- and that, therefore, inflation is a non-event for stocks. There are many other factors.

One important negative factor is that inflation effectively increases the real capital gains tax rate. The nominal rate only equals the real rate when inflation is zero. Because the capital gains tax is not indexed, any gains resulting purely from inflation give rise to phantom tax liabilities. It's easy to imagine a scenario in which an investor would show a gain in nominal terms, but a loss in real terms -- and still owe taxes. Inflation exerts a levered effect on real capital gains rates. For example, less than a 3% increase in inflation would effectively cancel the 5% capital gains tax reduction enacted this year.



This suggests that a shift to higher inflationary expectations would asymmetrically punish smaller, higher-growth, and higher-multiple companies. We have championed small-cap stocks and the technology sector as the big winners coming out of deflation, because they depend so critically on financial liquidity and incentives for capital investment. We need now to be on the lookout for a tipping point at which all the incentives start going the other way.

For stocks overall, even if we stipulate that earnings growth broadly tracks inflation, that's not to say that it could keep up with rising discount rates. That's because discount rates -- unlike earnings growth rates -- impound not only nominal opportunity costs, but *risks* as well. In other words, the high multiples we have enjoyed during the present epoch of low inflation were made possible not just by low nominal interest rates, but by *confidence* that rates would stay low. Thus a renewed bout of inflation would increase discount rates *twice* -- first by an outright inflation premium, and again by an inflation *risk* premium.

Another risk to bear in mind is that, while there may be short-term stimulative effects from the early stages of inflation, longer term inflation is a corrosive agent that degrades the growth prospects of the entire economy. Individual companies and sectors may prove to be big winners, based on factors such as their exposures to debt, foreign income, pension liabilities, unionized labor, natural resource intensivity, and so on. So there will be lots of opportunities for good stock-pickers and sector rotators. But that said, anytime monetary policy errors impose arbitrary rewards on some and punishments on others, the entire economy is forced to bear unnecessary and wasteful transactions costs and risks in order to deal with it. That's bad for growth.

For all these cautions, we are not at this moment making any changes to any of our Model Positions. We still think it's a good bet that the Fed will be forced by circumstances to raise rates in the first half of next year, and so we remain comfortable with our **short June Eurodollar** position. We are entirely comfortable with our levered **short 10-year Treasury notes** position, and our 50% **long high-yield bonds** position. And as an asset allocation position complementary to those two, we remain comfortable with our 75% **long S&P 500** position. As an outright long, though, stocks are becoming somewhat problematic, and we are alert for indications that some profit-taking is warranted. For the moment we are content to bet that the inflationary risks to which the Fed seems so blind have been more than fully discounted by stocks, which have not responded as they otherwise might have to economic news and earnings revisions that have been genuinely positive. TM