TrendMacrolytics

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MARKET CALLS

The Best Materials

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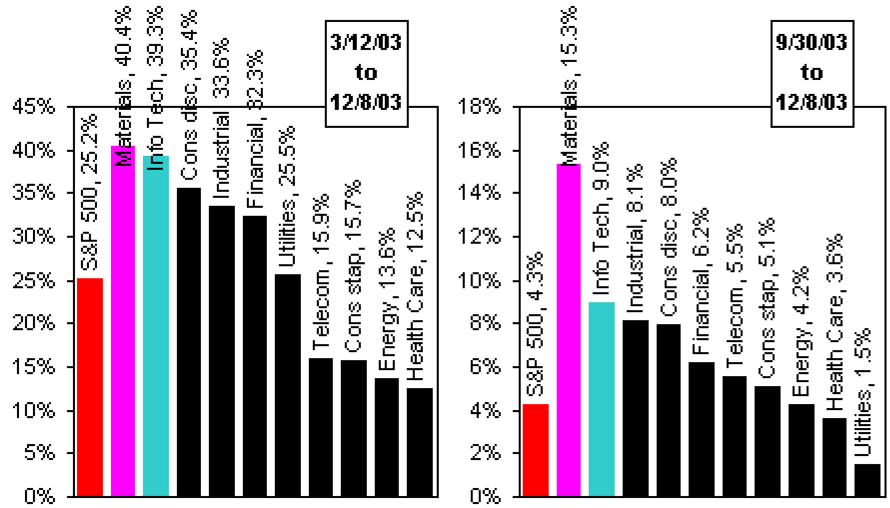
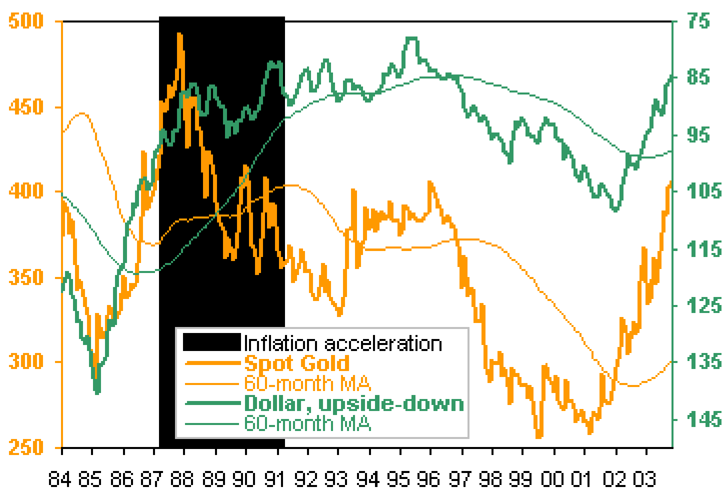
In stocks, a new fastest horse emerges as the reflationary expansion turns inflationary.

Ever since **President Bush** announced his intention to cut capital gains taxes early last year, we have said that the technology sector would lead the new bull market. And it has. But now another horse has come from behind and taken the lead -- the basic materials sector. It's high time to start placing some different bets.



As always, it's about policy. In this case, it's **the Fed's** inflationary monetary policy. Thanks to the Fed staying too easy for too long (see "Further Behind the Curve" December 8, 2003), it's no longer a question of *whether* there will be an acceleration in the rate of inflation. It's a question of how much, how long, and in what ways it will show up in markets, the economy and in various statistical measures.



The clearest evidence for an inflation acceleration is the fact that the most monetary of all markets -- gold and the forex value of the dollar -- are now in inflationary positions. The long-term moving averages of gold and forex turned up from their previously deflationary trajectories. While that is desirable to a certain extent as evidence of a healthy reflation, the spot markets are now so far above the moving averages that it seems nearly impossible to avoid an inflationary overshoot. This is exactly the configuration we observed the last time there was a period of accelerating CPI inflation -- the 4-year period beginning March 1987.

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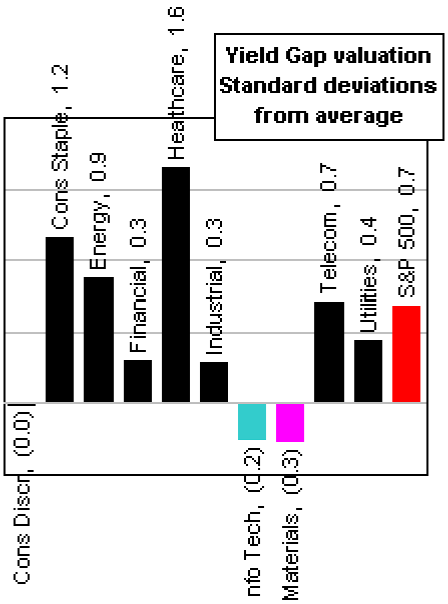
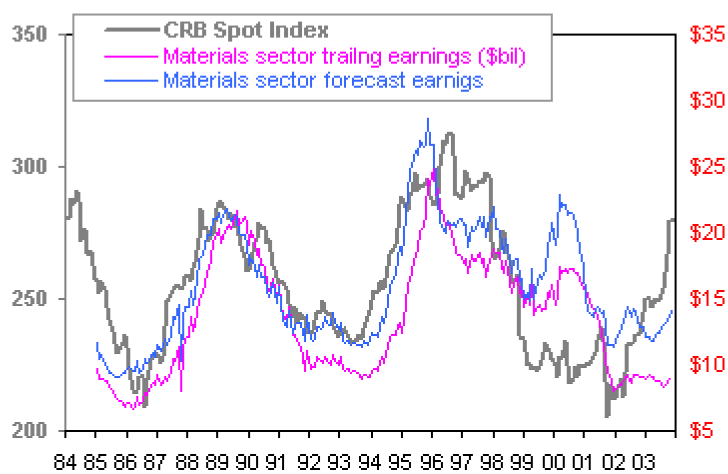


Neither the materials sector nor the tech sector has achieved its performance based on relative value. Through the bear market and this year's recovery, these two have consistently been the most overvalued -- or the least undervalued -- according our Yield Gap model.

These two sectors -- representing the extremes of the Old Economy and the New Economy -- may seem at first like an "odd couple" to be sharing the leadership in the present recovery. But they actually have had much in common.

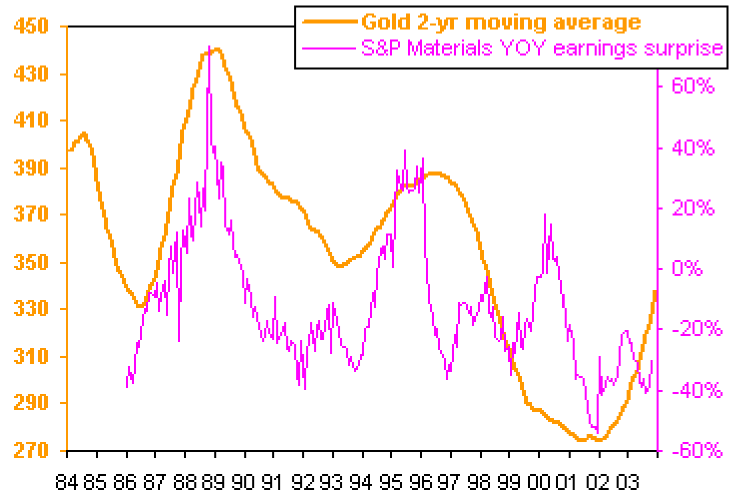
Both sectors are highly cyclical, and so both have been lifted by the rising tide of the business cycle recovery. At the same time, both sectors are major beneficiaries of the monetary reflation of the last year. The materials sector, obviously, has benefited from stabilizing (and now sharply rising) prices of its goods. Tech, on the other hand, is fueled by economy-wide risk-taking, both in terms of its corporate capital needs and the aggressive adoption of its products. Reflation has represented relief from the scarcity of liquidity and preference for cash-hoarding that kill risk-taking during a deflation.

But now, standing at the onset of a new inflationary acceleration, this may be the moment in which these two sectors part company. Yes, any impact that a new inflationary acceleration would have on the magnitude or longevity of the recovery would affect both sectors. But the materials sector stands to gain uniquely -- the transformation from reflation to inflation will continue to lift revenues and earnings dramatically.



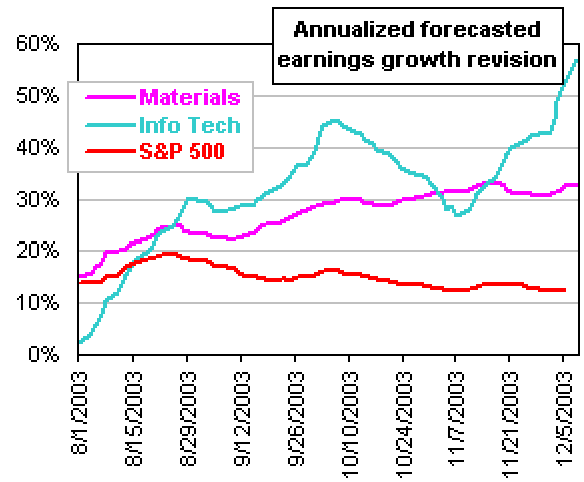
Broadly, earnings for the sector track the CRB Spot Index, as shown in the chart at right. One notable exception is the sharp rise in forecasted earnings at the top of the 1990s boom, while the CRB was falling. Actual earnings rose somewhat, but nowhere near expectations. It is almost as though industry analysts then were making the same faulty inflation forecast as the Fed. The subsequent deflation trashed both forecasted and trailing earnings. Now both have recovered somewhat, but nowhere near proportionately to the rally in the CRB. Once burned, twice shy? It seems that there is still plenty of room for forecasts to increase here.

There is also room for substantial recovery in trailing earnings, and potentially a big earnings surprise despite the very high percentage growth implied in the present difference between forecast and trailing. In the past, big earnings surprises have been associated with substantial upturns in the moving average gold price -- note the late 1980s and the mid-1990s in the chart on the following page. Today the moving average gold price is moving up rapidly. With the Fed seemingly primed to persist in its policy of hyper-ease, there is no reason to think it will stop. A big earnings surprise could be in the offing.

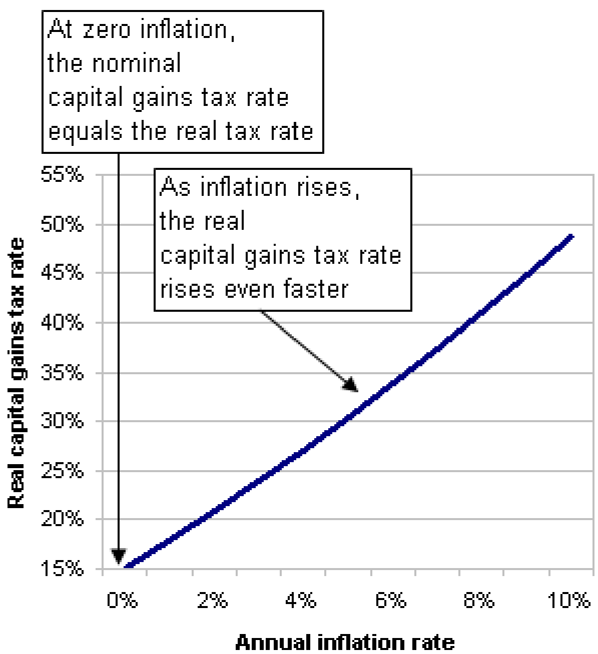


So the materials sector is poised for a hat trick -- a triple win, first from the reflation, second from the cyclical recovery, and now third from the prospects of inflation.

Tech has been a beneficiary of the first two factors. But it is not clear at all that a coming inflation will be helpful. The first wave of an inflationary acceleration can have unpredictably stimulative effects on speculative sectors of the economy and the market. And so far so good. Even though performance of the tech sector this quarter has trailed that of the materials sector, it still came in second -- it still beat all the rest. At the moment, tech and materials are both leading the way in terms of the acceleration of upward revisions in consensus earnings growth forecasts. At the same time, the overall S&P 500 is actually slowing down in terms of revision growth.



Bear in mind, though, that one special risk facing the tech sector is that an increase in the rate of inflation has the effect of increasing the capital gains tax rate -- to which the tech sector is very sensitive. Capital gains taxes are not indexed to inflation, so investors effectively pay taxes on nominal gains, not real gains. The higher the inflation rate, the more investors are taxed on gains that are strictly illusory. It is even simple to construct scenarios in which an investor would pay capital gains taxes on nominal gains, while taking a loss in real terms (a loss made all the greater once the tax is taken into account). We estimate that an increase in the rate of inflation of as little as 2% would effectively wipe out the lowering of the capital gains tax rate enacted as part of President Bush's economic package last July.



With the materials sector having performed so well, being not as undervalued as the rest of the market, and having already undergone such substantial earnings revisions growth, the natural question is: is it too late? We believe not. And while it seems *so 1970s*, we have established a new **Model Position long the materials sector**. We see it as a double bet, with attributes that are somewhat selfhedging. Obviously, it's an inflationary bet -- and we believe our inflation view is well out of consensus on the hawkish side. But at the same time, it's a bet on continuing expansion. So the hedge is: if the inflation kills the expansion, of if there is no inflation (yet the expansion continues), then the bet would pay of only one of two ways. If there is an inflationary expansion, it would pay off both ways. The bet would fail to pay off at all is if there is a renewed deflationary recession -- and we are confident that we can rule that scenario out.