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Inflationary Paradoxes

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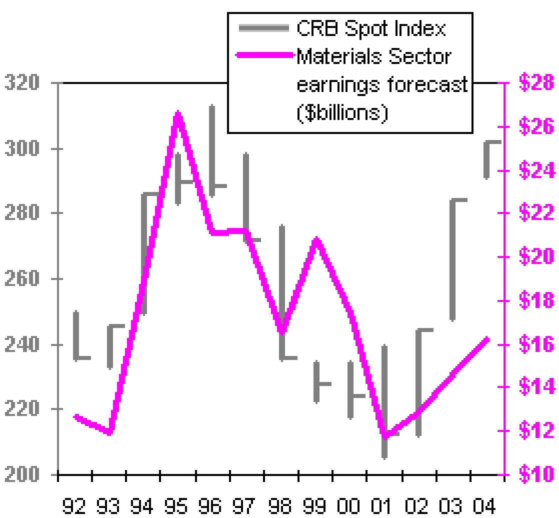
Markets struggle to come to terms with the reality of inflationary acceleration.

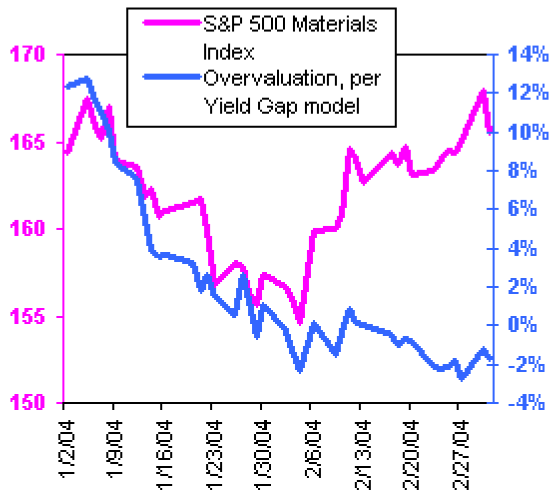
It's a time of paradoxes. We have been arguing for many months now that **the Fed** has fallen well behind the curve, staying too easy for too long, and that a non-trivial acceleration of inflation has been set in motion. We regard this to be a non-consensus view, believing that most investors have wholly accepted the Fed's claims that inflation has been removed as a threat. Indeed, as we talk to investors about the revival of inflation, a clear majority tell us that we are wrong -- that this time it's different -- and almost every one of them thinks he's the *only* one who thinks so. In our view, *that's* the consensus.

Another paradox: increasing inflationary evidence continues to be reflected in some market-based indicators, with commodities making new highs on Monday and the spread between Treasury bonds and inflation-protected TIPs widening to levels not seen since 1997. At the same time, though, gold and the forex value of the dollar have pulled back from their worst inflationary levels, and market-based expectations for Fed interest rate hikes have shifted somewhat forward in time. It would seem that the market is coming to terms with the reality of inflationary risk, at the same time as it is estimating that the worst-case version of that risk will be avoided.

Here's another paradox -- but this is familiar one. Stocks have been weak the last couple days as rate-hike expectations have become slightly more aggressive, the conventional wisdom being that the Fed is beginning to take away that famous punchbowl. That might be a valid concern if you start from the premise that there is truly no risk of inflation. But against the backdrop of the reality that inflationary acceleration is already well underway -- as reflected in gold, commodities and the forex value of the dollar -- then rate hikes are long overdue, and should in fairly short order act as an accelerant and lengthener of the economic recovery. Any pullback in stocks based on rate-hike expectations is, therefore, that "buyable dip" that we've been talking about for months.



What about the inflation-sensitive **Materials Sector**? More paradoxes. Commodities prices have made new highs this week, within striking distance of all-time highs, and so has the S&P 500 Materials Sector index (while, of course, the overall S&P 500 remains well under its historic highs). Forecasted earnings for the Materials Sector are being revised upward at an unheard-of 124% annualized pace. Yet even at that, forecasted earnings are still far below those achieved last time commodities prices were at today's high levels (see the chart at left). And year-to-date, at the same time as the Materials Sector flirts with new all-time highs, it has gone from somewhat overvalued (according to our "yield gap" valuation model) to slightly *under*valued (see the chart below). If we are correct that the Fed has waited too long to act, then the inflationary impulses already pipelined ought to leave a great deal of room for continued earnings forecast growth.



Yet another paradox: even as earnings forecasts have soared, the conventional wisdom on materials stocks this quarter is that they've been victims, rather than beneficiaries, of the rising prices of materials, and other factors that point to inflationary acceleration. **Alcoa** kicked off earnings season with a disappointing report, pinned on high fuel costs and a falling dollar. Chemicals stocks like **Dow** and **Dupont** have been bad-mouthed by analysts because of the high cost of natural gas, a key input to many of their products. If you assume away the dynamic of inflationary acceleration, then these seem like real issues. But as inflation accelerates, companies find themselves with pricing power they didn't know they had. Alcoa will have a lot easier time selling aluminum at higher prices now that **Coors** and **Anheuser Busch** have both discovered that they can raise the price of beer. To the extent that our call for accelerating inflation is both correct and out-of-consensus, newly discovered pricing power will generate upside surprises for the Materials Sector.

As a not insignificant side note, we would point out that the Materials Sector and the Information Technology Sector are both very sensitive to the risks engendered in the current debate about "outsourcing." Tech companies are both major users of and suppliers to the outsourcing movement. Materials companies are beneficiaries of the third-world infrastructure boom that has been strongly stimulated by outsourcing. It's a political year, and issues like this are volatile. But our reading is that the issue has probably climaxed in the public mind, and that we can be fairly confident we've gotten through it without any new protectionist initiatives from the **Bush administration** having been set in motion. TM