TrendMacrolytics

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# Coming to Terms with Inflation Reality

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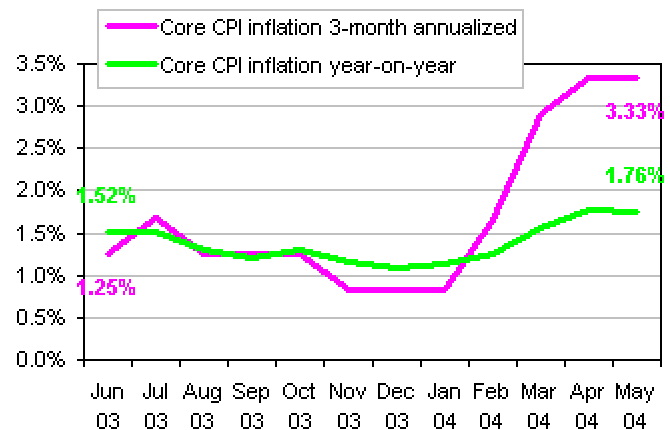
**Most investors don't "get it" that inflation is alive short-term, and that disinflation is dead long-term.**

We were a lone voice in the wilderness a year ago when we first started warning about the resurgence of inflation (see "How Much Room?" June 11, 2003). Along the way others have joined us in our fears, and even the backward-looking government price statistics have begun to prove us correct. Yet this still feels to us like an out-of-consensus call. Short term, we see markets failing to price for what we see as the virtually certain acceleration of reported core inflation to at least 3%. Longer term, we think investors will be challenged to adjust to the fact that we stand now at a generational milestone -- the end of a quarter-century bear market in inflation.



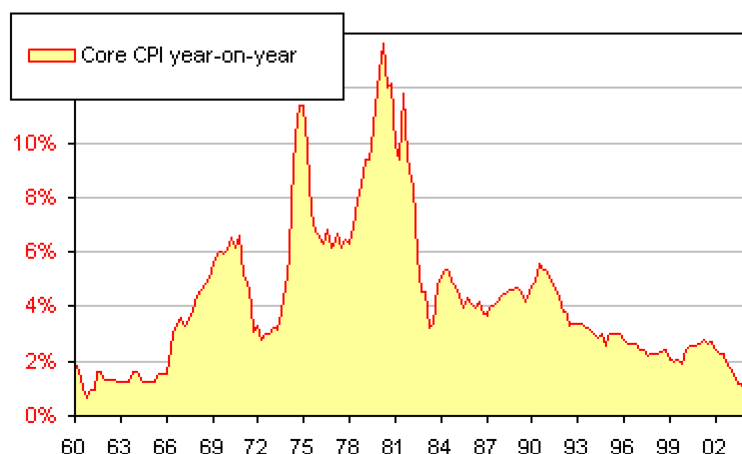

First, the short term. **Fed** officials continue to regularly make statements to the effect that inflation will remain "well contained" and that it is "not likely to be a serious concern." But in our view, the forces that will propel core CPI inflation to 3% within the next 18 months are already in the pipeline -- no matter what the Fed does now. To any extent that the Fed's "measured" approach to raising interest leaves policy too accommodative, those forces in the pipeline will be *increased*. So by the time we see 3% in the official statistics -- and the Fed and everyone else finally starts to see inflation as "*not* contained" and "*likely* to be a serious concern" -- inflation rates *above* 3% will be unavoidable.

Whose view really represents the consensus -- ours or the Fed's? Judging by the Treasury bond market, our view is still very much out-of-consensus. While yields are certainly higher than they were three months ago when rate-hikes seemed further in the future, Treasuries remain deeply under the spell of the Fed's feel-good assurances about inflation. Today 10-year yields at 4.71% are trading with a 295 basis point spread above the current year-on-year core CPI inflation rate of 1.76%. That spread is only slightly above the 274 point average that has obtained since 1958, a near half-century encompassing all types of inflationary and disinflationary environments. This broadly suggests that the Treasury market expects virtually no increase in inflation from today's levels. When we are soon proven correct that core CPI inflation will run at no less than 3%, we would expect to see the 10-year yielding something like 5.74%. *Then* we'll say our inflation call is in-consensus. In the meantime, shorting long-term Treasuries remains an

outstanding speculative opportunity, no matter how often we hear from hedge fund managers that they believe all the *other* hedge fund managers are doing it.

For equities it's harder to tell how much of our inflation call is already in prices, or if it even matters. Equities are sensitive to a wider variety of factors than Treasuries are. And an acceleration of core inflation to 3% would not necessarily make all that much difference to equities, once the offsetting positive and negative dynamics all netted out -- while its purely negative dynamics will make a world of difference to Treasuries. For equities the real inflation risk now is not inflation itself, but the Fed's panicked and over-aggressive reaction if it finds itself having fallen far behind the curve six months to a year from now. That's why throughout this year-to-date's stock market malaise we've been suggesting "buy the dip" when stock prices fall on rate-hike fears. Nothing would be better now for equities than a decisive and prompt rate-hiking regime -- which would prevent a panicked tightening episode later. Yet now that we are nearer to top end of the year's trading range, we are cautious -- it is far from certain that the Fed is going to do the right thing.

The acceleration of core inflation to at least 3% in the near term is only part of today's inflation reality -- investors may be overlooking a longer-term dimension as well. No, we are not forecasting that that the coming resurgence of inflation will develop into another full-blown bout of 1970's-style hyperinflation. Rather, we are drawing attention to the fact that no matter what happens with inflation now -- even if the Fed somehow manages policy just perfectly and inflation stabilizes right where it is today -- it remains the case that a 24-year bear market in inflation has come to an end. The disinflationary trend from the June 1980 peak of hyperinflation is over. Inflation *doesn't have to get worse* for this to be true. The fact remains that *inflation has no room to get better*. The Fed has made it perfectly clear that it regards inflation in the range of 1% to 2% as policy-optimal. This is the bottom, then. This is as good as it gets.

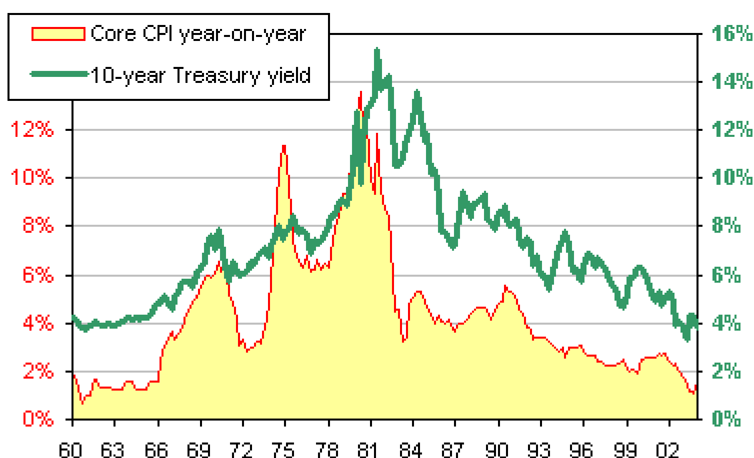



Let's switch gears and set aside the high probability of an acceleration of inflation in the near term or, if you like, assume that such an acceleration will be quickly brought back under control. Let's think only about the dynamics of a hypothetical new world in which the rate of inflation is no longer falling because it is, at least generally, stable at effectively zero. That would be a beautiful world. No single factor could be more positive for sustainable growth than a rate of inflation stable at effectively zero. Yet at the same time, such an environment would come as a disappointment to a generation of investors who mistakenly think that the last 24 years of disinflation is the way markets behave all the time. The bear market in inflation has been a rising tide that has lifted the boats of both fixed income and equities, and that tide has now fully come in. But it's a special kind of tide. Having come *in*, this tide need not ever go *out*. To the extent that it stays in, then markets will have the advantage of being at the high tide of *effectively zero* inflation, but they will *not* have the advantage of the rising tide of *falling* inflation.

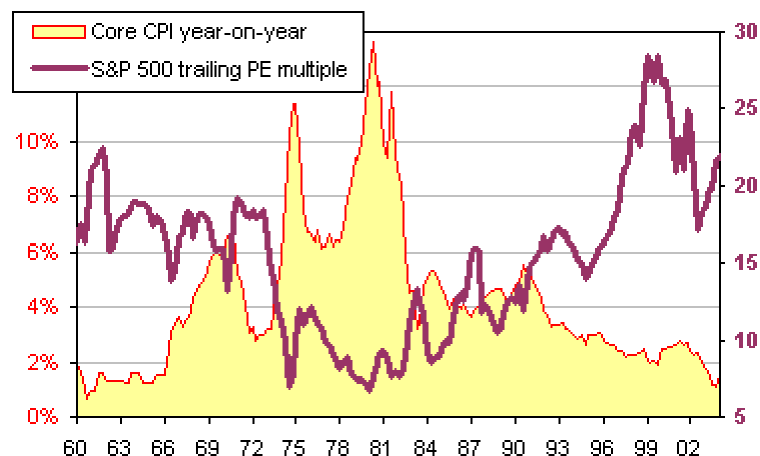
Yes, it has been commonplace commentary for many years to say that "inflation is dead." Our point is a different one -- that the *process* of inflation's dying is over. In other words, *disinflation*

*is dead*. This is true whether or not you agree with us that inflation will reaccelerate in the short term. Either way, inflation has no more room to decelerate.

The great Treasury bull market of the last 24 years has been exclusively the product of that deceleration -- ever-lower inflation has driven ever-lower yields, which in turn have driven ever-higher total returns. But for Treasuries, there's no special advantage to being at today's high tide. Indeed, from here there's nowhere to go but down, if we rule out the possibility of another bout of monetary deflation. Treasuries are all risk and no upside now. The best you can hope for is to get your money back in ten years, plus interest.



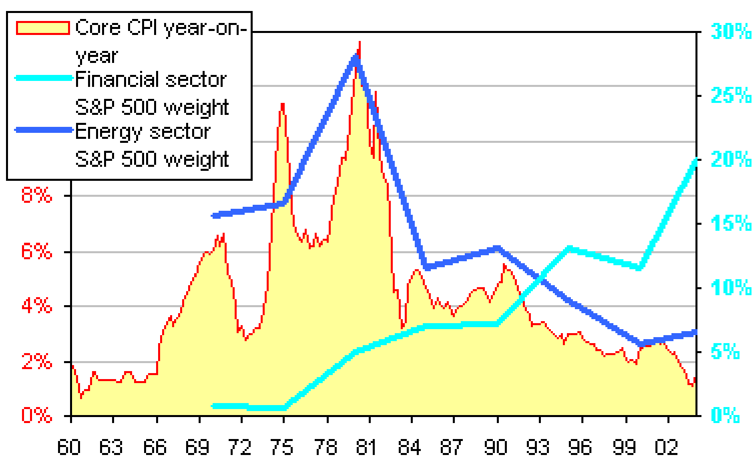

Equities have also been benefited by the last 24 years of decelerating inflation. The bear market in inflation has been responsible for a bull market in price/earnings multiples. Why? First, lower inflation means lower discount rates in equity valuation. Second, lower inflation means lower real capital gains tax rates, and therefore higher after-tax expected returns (because the capital gains tax is not indexed for inflation). Third, lower inflation means both higher real earnings growth and higher-quality earnings growth.




All those same reasons -- in reverse -- created the low p/e multiples of the 1970s. Those low multiples were therefore appropriate for the inflationary conditions that prevailed at the time. They only represented "value" to the extent that one foresaw the coming disinflation of the next quarter century. Investors like **Warren Buffett**, who took large undiversified positions in "value" stocks then may well have been right for the wrong reasons. Buffett now complains that there are no stocks that he considers worth buying at today's prices. Yet today's "values" are really no worse than the ones that obtained during his heyday -- when adjusted for today's inflation conditions. What's different is that today inflation conditions have no room to get better. So whether you call it "value" or you call it "riding the tide of falling inflation," that game is now completely played out. You can't count on multiple expansion as a secular tailwind anymore. Today stocks have to make it the hard way: through earnings growth.

The good news is that an effectively zero-inflation environment would be earnings growth-optimal. So while the end of the bear market in inflation spells the end of the bull market in Treasuries, for equities it's only a challenge -- not a death sentence. Will long-term equity returns be lower in a new zero-inflation epoch than they were during the last 24 years of disinflation? Probably, since we can no longer count on multiple expansion as a guaranteed

bonus. But nothing in this framework suggests that lower returns in the future are in any way a "payback" for excessively high returns over the last two decades, or that today's high multiples must now "revert to the mean." This framework suggests that we fully deserved those high returns over those years, and today's high multiples, as the reward for successfully engineering the death of inflation.




That's not to say there won't be winners and losers. For companies and sectors whose earnings are tied to the prices of commodities -- such as the energy and basic materials sectors -- the bear market in inflation has been a 24-year curse of falling real prices and eroding margins. At the peak of inflation in 1980, the energy sector dominated the S&P 500 with 28% of the index's capitalization weight. Today it stands at 7%. The stabilization of inflation at effectively zero doesn't argue for a return to energy's glory days. But to the extent that the market hasn't grasped the significance of the sector's liberation from the curse of disinflation, then energy stocks are priced too cheap. Indeed, while energy has been the best-performing S&P 500 sector year-to-date (up 11.6%, not including dividends), it is nevertheless the second most undervalued among the ten major sectors.

While the energy sector has been in eclipse for the last quarter century of falling inflation, the financial sector has been in ascendancy. Today it is the S&P 500's largest sector, at 20% of the index's market capitalization (it was as high as 22% one year ago). Yet in 1970, it was less than 1%. Back then the financial sector wasn't considered important enough to merit significant presence in an index geared to reflect an industrial and resource-driven economy. It wasn't until the S&P 500 was fundamentally redefined in the late 1970s that banks and other financial services companies got any meaningful representation at all -- at about 5%. While the epoch of disinflation was a curse to energy, it was a blessing to financials -- declining inflation has the effect of automatically increasing the real earnings of companies whose primary business is money-lending, because the money is paid back in relatively more valuable dollars. Now that the blessing of disinflation has come to an end, the financial sector won't slip back into obscurity. But it's likely to eventually lose its top position to some other sector that finds its advantage in an effectively zero-inflation world.

Let's recap. Short term, investors are failing to appreciate the virtual certainty that inflation will accelerate. Long term, investors may not understand the implications of a world in which inflation simply has no more room to decelerate. In the short term, there will be plenty of risks arising from inflation's reacceleration -- especially for Treasuries, and eventually perhaps for equities. But in the long term, even assuming that inflation does not reaccelerate, the mere fact that it is no longer decelerating will redefine the underlying structure of returns, and create new opportunities for changes in sector leadership. TM