TrendMacrolytics

Donald Luskin, Chief Investment Officer
David Gitlitz, Chief Economist
Thomas Demas, Managing Director

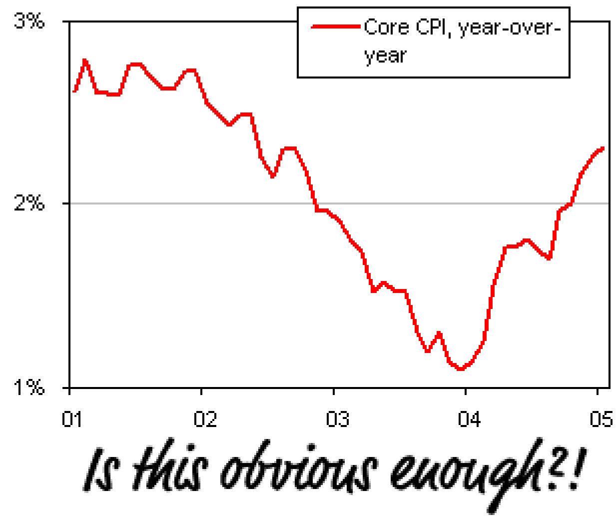
MACROCOSM

Inflation Now

Monday, March 14, 2005

Donald Luskin

Undervalued stocks have absorbed the inflation scare that has devastated bonds.



We started seeing the first hints of the inflation concerns that have gripped markets this month as far back as June, 2003 (see "How Much Room?" June 11, 2003). Since then we've gradually turned up the level of our concern, as the behavior of gold and other commodities, energy and foreign exchange continued to point to growing inflation risk. But even as our predictions have been palpably borne out in a sharp and obvious trend change in even the lagging official price indices, the conventional wisdom continued to treat inflation as something between a triviality and an impossibility, with only brief and intermittent episodes of inflation awareness -- and those always corresponding to short and sharp back-ups in the Treasury market which, otherwise, has consistently presented the strongest rationale for inflation denial.

We're in one of those episodes of awareness right now, corresponding with the back-up in Treasury yields from 3.97% on February 9 to over 4.5% now, just over a month later. The back-up this time has, once again, been sharp. Perhaps this time it won't be short. It's one thing for yields to rise as the Treasury market reassesses the likely pace of **Fed** rate hikes (indeed, futures markets are now priced for a 25 basis point hike at every **FOMC** meeting this year but one, after expecting what we said was a virtually impossible three passes just a month ago). But it's quite another thing when, at the same time, other market-based indicators of inflation risk are saying that this newly forecasted Fed vigilance won't be enough to stanch mounting inflationary impulses. Over the same period as the 10-year yield has tacked on 55 basis points, crude oil has moved up to challenge its all-time highs notched last year. Gold is challenging its recent highs, and dollar has all but given up its gains in this year's aborted rally. Thus it seems we face a situation in which the Fed is expected to be both more aggressive and not quite aggressive enough.

Over the same period stocks are higher. Having made 3-1/2 year highs just last week, the **S&P 500** now stands about 1% higher than where it was on February 9, when the 10-year yield bottomed at 3.97%. This remarkable result in the face of an inflation mini-panic is, in part, testimony to the fact that stocks were so very sharply undervalued then (see "A Question of Value" February 14, 2005). But it's also the case that stocks have been buttressed by the outstanding performance of inflation-sensitive sectors, with **Energy** up about 9% and **Basic**

http://www.trendmacro.com
don@trendmacro.com
dgitlitz@trendmacro.com
tdemas@trendmacro.com

Offices:
Menlo Park CA
Parsippany NJ
Charlotte NC

Phone:
650 429 2112
973 335 5079
704 552 3625

Materials up about 7% since February 9. Without the performance of those two sectors, the S&P 500 would have been about unchanged over the period. Over the same period, the negatively inflation-sensitive **Financials** sector (the S&P 500's largest, by market capitalization), has been off by about 2%, costing the overall index about one half of one percent in performance.

Stocks remain deeply undervalued -- based on comparing the S&P 500 forward earnings yield to the long-term Treasury yield, versus historical norms -- although not as radically as they were a month ago when Treasury yields were much lower. Therefore, we continue to see stocks as already having discounted, to a large extent, the inflation risks to which the bond market has been so blind. To say the same thing with a finer point on it, stocks have already discounted a more inflation-aggressive interest rate environment, while bonds have not. We don't see the likely level of inflation itself to be especially corrosive to the economy -- a rate of 3% core CPI inflation would still be fairly benign in macro terms. So while such an inflation rate would be difficult for Treasuries, we continue to be positive on the macro economy, perhaps all the more so to the extent that the renaissance of inflation awareness will lead to more decisive preventive action (while such action can still be effective without being draconian). For us, the biggest inhibitor to growth -- and to stocks, as can be seen in the lackluster performance of the growth-sensitive **Technology** sector -- is the chaotic policy environment in which the expanded **Republican** majority seems so reticent to act on its mandate to extend the 2003 tax cuts, and all too willing to negotiate with **Democrats** on tax hikes in connection with **Social Security** reform.

Bottom line: Stocks are already discounting an inflation-aggressive rate environment to which bonds remain vulnerable, so we see very little downside here in a still positive macro environment. As inflation awareness continues to grow, we continue to favor positively inflation-sensitive sectors. Until tax policy uncertainty abates, stocks will have difficulty absorbing the full extent of their still considerable undervaluation. We continue to be far more optimistic than the media consensus that positive policy resolutions can be achieved. So we would see a period of weakness or stagnation in stocks here as a buying opportunity with little downside and considerable upside. TM