TrendMacrolytics

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The End of a Theme

Tuesday, March 29, 2005
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If the Fed follows through, it's good for stocks and bad for the reflation/inflation plays.

With **the Fed's** admission last week of mounting inflationary pressures (see "About Time" March 23, 2005), the lay of the land has changed for equities. Let us make the critical and risky assumption that the Fed now follows through on rate normalization through "measured" hikes -- where "measured" can now be retranslated as meaning "consistent" rather than "lethargic." The conventional wisdom is that this will be bad for equities, because discount rates used in equity valuation will have to rise with interest rates. While that is true on the face of it, it is an unrealistically narrow "all things equal" analysis in a world where all things are *not* equal. There will be winners and losers, but we think that a more vigilant Fed will be very good for equities overall.

The key concept here is that prompt rate normalization here will take the worst case growth-killing inflation scenarios off the table -- while it is still possible to do so without growth-killing shock treatment. So while valuation models will indeed now have to assume higher interest rates in the future, they should also assume higher and more sustained growth rates. The two assumption changes -- one negative for valuation and one positive -- offset each other.

Moreover, two important dynamics come to the fore when you remember that equity valuation is a *nominal* exercise, not a *real* one. First, in nominal terms, declining inflation risk acts as the analytical equivalent of rising earnings quality -- because an exogenous source of uncertainty in nominal earnings is reduced. So not only are growth rates higher when worst-case inflation risk is taken off the table, but at the same time growth is *more valuable* in certainty-equivalent terms. Second, nominal growth is also more valuable *after taxes* under lower inflation assumptions, because the capital gains tax is not indexed for inflation. The higher the inflation, the higher the effective capital gains tax rate in relation to *real* capital gains.

Put it all together and our conclusion is that equities are benefited far more by the removal of the threat of worst case inflation scenarios than they are harmed by the restoration of higher interest rates that would be, after all, not high in any absolute sense but merely *normal*.

On top of all that, as we have argued for several months, we see equity valuations as already having more than discounted significantly higher interest rates (see, for example, "A Question of Value" February 14, 2005). As of Friday, the S&P 500 was undervalued relative to historical norms so as to imply long-term Treasury yields 159 basis points higher than they are today. That's only 9 basis points more than the cumulative rise in short term rates that would result if the Fed hiked the funds rate by 25 basis points at each **FOMC** meeting this year -- which is a good baseline scenario for the Fed fulfilling its newly redefined "measured" regimen. But that doesn't mean the Fed would hike away all the undervaluation in stocks. With the funds rate at 4.25% at year end, it's unlikely that the yield curve would be as steep as it is now -- which means that long bond yields would rise less than the 150 bps by which the funds rate had risen.

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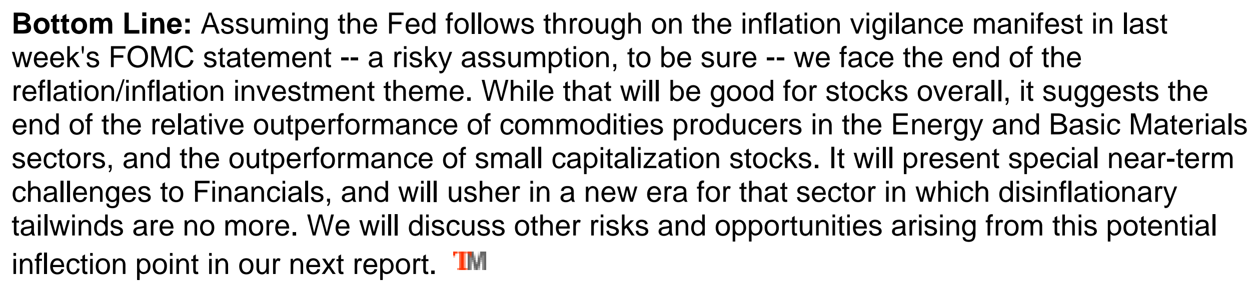
Moreover, by the time year-end rolls around, S&P 500 earnings should be at least 8% higher than they are today (based on consensus forecasts that may well be too conservative). Taken together, that would leave equities still significantly undervalued, despite higher short-term interest rates. Or to put it another way, it would take higher stock prices at that point to return equities to normal valuations.

So we remain confident about equities overall. But if last week's FOMC meeting really was an inflection point in terms of the alleviation of inflation risk, then it ordains the demise of an important investment theme -- the recovery from the monetary deflation that bottomed in 2002, a recovery which has been at risk this year of curdling from a salutary reflation into a pernicious inflation. The demise of the reflation/inflation theme knocks out what we see as the most important underpinning for the bull case in the **Energy** and **Basic Materials** sectors. As metals, crude oil and other commodities have risen over the last three years as the most sensitive leading indicators of, first, reflationary and, then, inflationary expectations, these sectors have been propelled into the number one and number two best performing spots in this bull market. But now, if the Fed follows through, then we've probably seen the highs in oil and commodities. Accordingly, we have closed our long-standing **Model Position in the Basic Materials sector**, with a 17.7% gain (not including dividends) since inception, just less than twice the comparable gain for the S&P 500 over the same period.

But the end of the bull case doesn't necessarily make a bear case in these sectors -- though it does mean the easy money is off the table. Both have been subject to speculation in recent months, and may undergo a deep speculative reaction as inflation risk recedes. Ironically this would come just as inflation will be increasingly discussed in the media, which typically focuses on whichever "yesterday's war" the Fed happens to be fighting at the moment. An excessive reaction could be a buying opportunity. First, earnings in these sectors are highly responsive to growth expectations, and such expectations are improved by the removal of worst-case inflation scenarios. And second, just because the worst-case inflation scenarios have been removed, that doesn't suggest that commodity prices must revert to their pre-inflation means -- going forward, the inflation already on the books and in the pipeline will assure that mean commodities prices will be higher, and higher *longer*, than those assumed in the consensus earnings model (especially in Energy -- where earnings upgrades have been grudging to begin with this year).

In the short run, **Financials**, or any companies that have fed on the "carry trade" made possible by artificially cheap and low-volatility dollar financing, are in for some disappointments as that financing is withdrawn. Levered positions will have to be unwound, and messy blow-ups are possible. Longer-term, the removal of worst-case inflation scenarios is a plus for Financials -- nothing is worse than higher than expected inflation for any company whose basic business model is money-lending. But none of that alters the fact that, for a sector that has used more than two decades of consistently falling inflation to grow into the largest equity sector by market capitalization, the era of free rides is over, even if inflation were contained at zero forever.

We would also suggest that a careful eye be kept on small cap stocks. We don't have a fully satisfying theory as to *why*, but our research has found that perhaps the single most reliable relationship between inflation and equity valuation is that the small stock premium is correlated to inflationary expectations as reflected in the gold price. In other words, small stocks outperform large stocks when gold is rising, which reflects rising inflationary expectations. If we've seen the top now in gold and in inflationary expectations, then we've possibly also seen the top in the small stock premium -- which, over the last several months, had been sufficient to propel small stock indices to new all time highs. This is not to say that small stocks will perform badly in *absolute* terms -- but it suggests that the recent years of especially strong *relative* performance have come to an end.



Bottom Line: Assuming the Fed follows through on the inflation vigilance manifest in last week's FOMC statement -- a risky assumption, to be sure -- we face the end of the reflation/inflation investment theme. While that will be good for stocks overall, it suggests the end of the relative outperformance of commodities producers in the Energy and Basic Materials sectors, and the outperformance of small capitalization stocks. It will present special near-term challenges to Financials, and will usher in a new era for that sector in which disinflationary tailwinds are no more. We will discuss other risks and opportunities arising from this potential inflection point in our next report. TM