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MARKET CALLS

Inflation Plays Revisited

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The worst case inflation risk is off the table, but risk remains as growth accelerates.

We observed earlier this week that stock prices, now at all-time highs, are self-evidently driven by *growth* prospects -- which are rising -- and not hopes for rate cuts -- which are falling (see "Rodney Revisited" May 29, 2007). How will the interaction of growth and inflation expectations impact the performance of the energy and basic materials sectors -- the "inflation plays" that have been our favorite equity sectors, and such stellar performers so far?

By way of background, since the bottom in the equity market in October 2002, energy has been the best performing of the ten major S&P 500 sectors (up 209.5% excluding dividends, versus 97.0% for the S&P 500), and materials has been third best (up 144.8%). Over the intervening years we've gone through various changes in our strategic views on these sectors, sometimes positive and sometimes negative. Our most recent strongly positive change of view was September 28 of last year, when commodities prices fell during the Amaranth crisis (see "The Frustrated Fed" September 28, 2006). Since then, energy and materials have been the best and second best performing sectors, respectively (up 28.1% and 27.4%, versus 14.3% for the S&P 500).

Update to strategic view
US RESOURCE STOCKS: The worst case inflation risk of Fed rate cuts is off the table, and that diminishes some of the impetus driving inflation-sensitive sectors. But reaccelerating US growth is not only a positive for industrial commodities, but also increases the inflation risk for a Fed that continues to stay on pause. The strongest bull case for the "inflation plays" is diminished, but the framework for superior performance remains in place.
[see Investment Strategy Dashboard]

The energy and materials sectors are driven jointly by growth and inflation. Let's consider both factors in light of diminishing expectations for Fed rate cuts.

- Growth is visibly reaccelerating (for example, this morning's upside blow-out Chicago PMI). Growth has never been contingent on artificially low interest rates administered by the Fed. Consider that the consensus forecasted S&P 500 earnings growth rate now stands at a very robust 12.8%, marking 5-1/2 years and counting at double-digit levels, undeterred by the fact that the Fed funds rate is no longer at 1%. It's the other way around: interest rates are contingent on growth. It is the visible resurgence of growth, and the evident immunity of the broad economy to weakness in the housing sector, that

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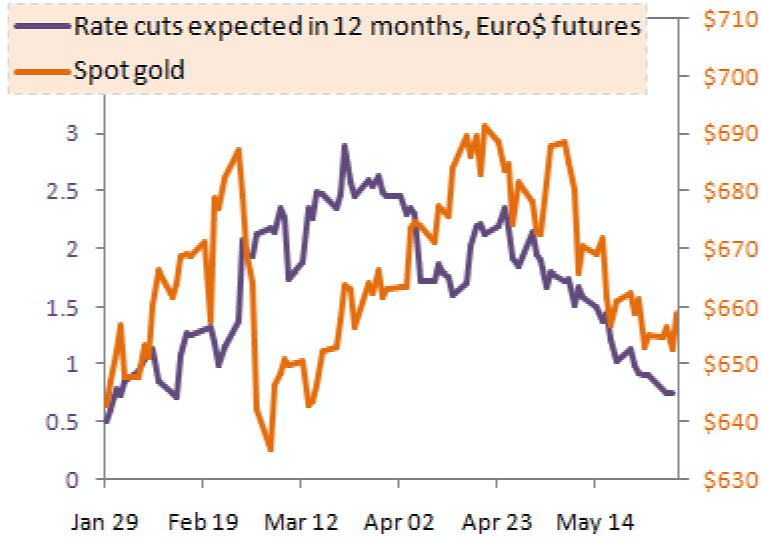
has convinced the market that the Fed is not likely to cut rates.

- With the falling likelihood of Fed rate cuts that would have exacerbated existing inflation pressures, the worst case for inflation is probably off the table. Consider the interaction of gold -- the most sensitive indicator of inflation risk -- with rate cut expectations implied by the Eurodollar futures market. In late January, those expectations were about where they are today. They rose dramatically as the crisis in subprime lending raised the risk of recession, and have fallen back as that risk has receded. The gold price went through a generally parallel cycle, indicating that the likelihood of rate cuts closely connects to the risk of inflation.



  But even though the worst case for inflation is off the table, there is still significant risk. As the economy reaccelerates, we expect that the Fed will remain on pause for a considerable time, until it somehow gets comfort that the problems in the housing sector won't become a broad contagion. Based on the minutes of the May 9 FOMC meeting released yesterday, it would seem that the Fed currently expects it may have to wait much of this year for that comfort to develop. While the Fed waits, a funds rate stuck at 5.25% gets implicitly easier, as rising available returns drive increased borrowing from the Fed. We saw an instance of this in late 2005 and early 2006 when the Fed was still raising rates, but not rapidly enough to keep up with the pace at which the economy was then growing. That episode led to a surge in gold and other inflation-sensitive markets, and it's entirely possible that the same thing could happen again now.

With growth reaccelerating and inflation risk still active, we think the energy and materials sectors are still attractive -- especially considering that, based on our equity risk premium model, they are the first and third most undervalued S&P 500 sectors, respectively, even given their outstanding performance. At some point, as we have said so often, we expect that the Fed will have to raise rates aggressively to root out the inflation pressures that it is has let build up for the sake of guarding against housing contagion. Then the energy and materials sectors will be put squarely in the crosshairs, as the Fed's belated actions take their tolls on both growth and inflation. Once that happens, energy and materials won't be the only sectors at risk. The financial sector, the largest in the S&P 500 -- grown complacent in a world of infinite liquidity in which credit risk is effectively unpriced and without consequence -- will be slammed when the Fed drains that liquidity, and the price and consequences of credit risk return to normal levels.

As a short term matter, without respect to particular equity sectors, we can't fail to mention the consequences of falling rate cut expectations having driven up interest rates across the yield curve. This puts pressure on the equity risk premium of the S&P 500 relative to the 30-year Treasury, driving it to its narrowest level since January 2005. While this is one of the narrower points in the last five years, compared to the long sweep of history, today's risk premium is actually quite wide (prior to 2002, there were only two times in the last quarter century in which it was wider than it is today). So while we think that the reacceleration of growth and the wider-than-historical risk premium is a positive for stocks, in the very near term the narrower-than-recent risk premium is a negative, and probably portends a short period of correction or consolidation.

BOTTOM LINE: Global growth, including reaccelerating US growth, continues to be a driver for continued superior performance for the energy and basic materials sectors. Cutting against that, as the possibility of Fed rate cuts recede, the risk of a worst case inflationary error by the Fed is probably off the table. That said, as US growth reaccelerates, remaining on pause becomes an increasingly inflationary posture for the Fed. So while the very strongest bull case for the "inflation plays" has lost some of its impetus, the framework for continued superior performance remains in place.