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MARKET CALLS

Inflation Inflection

Tuesday, March 25, 2008

Donald Luskin

The Fed pulls back from the inflationary brink, and we call the top on "inflation plays."

After last Tuesday's FOMC meeting, and before the opening Wednesday, we moved to a cautious view on the "inflation plays" -- the energy and basic materials sectors, gold, oil, commodities, and the dollar short (see "Three Quarter Profile In Courage" March 19, 2008). The Fed's decision to disappoint market expectations by cutting the funds rate only 75 bp -- and the positive reaction to that decision in markets for risky assets, and the narrowing of expectations for further rate cuts -- gave us hope that the Fed had finally found the key to arresting the credit crisis while avoiding the worst-case inflationary excesses that had been anticipated by the inflation plays. Now, with several more days to observe the aftermath of the Fed's decision, it seems that we may have nearly perfectly called the top.

Since Tuesday's close, the inflation plays have been the weakest elements in the markets -- energy stocks have fallen 3.7%; materials stocks have fallen 3.8%; gold has fallen 6.8%; oil has fallen 7.5%; and the trade-weighted forex basket has fallen 2.4% against the US dollar. At the same time, stocks have continued to rally from their panic lows of Monday of last week, led by the embattled financial sector, affirming our white-knuckles call Monday morning to buy into weakness (see "Bernankruptcy" March 17, 2008). And expectations in futures markets for further Fed rate cuts have continued to narrow, now showing only a single 25 bp cut fully anticipated in this easing cycle.

Update to strategic view

US RESOURCE STOCKS, GOLD, OIL, COMMODITIES, US DOLLAR: Following last week's caution, we are going to neutral and moving off our long-standing and very profitable positive view. With financial system meltdown averted and less inflationary tools now in the hands of the Fed, the worst-case inflation scenario is off the table. These are growth plays as well as inflation plays, and the reduction of inflation risk raises the present value of long-term growth prospects. But for the near term, the major driver of their recent momentum -- inflation expectations -- has been significantly reduced.

US STOCKS, US BONDS: Stocks (still impounding a near-record equity risk premium) and non-exotic debt instruments (driven to firesale prices in forced de-leveraging liquidations) are way out of whack with strong underlying corporate fundamentals. Last week's near-death experience should be a durable bottom in equities, junk bonds, leveraged loans, muni's and closed-end muni funds.

US FINANCIAL STOCKS: With systemic risk averted by the Fed's new tools, the worst has probably been seen for this sector. But after such sharp recovery in the last week, the easy money is out of the trade. It makes more sense now to be a direct creditor in beaten-down debt markets, rather than an equity holder in still troubled credit intermediaries.

[see Investment Strategy Dashboard]

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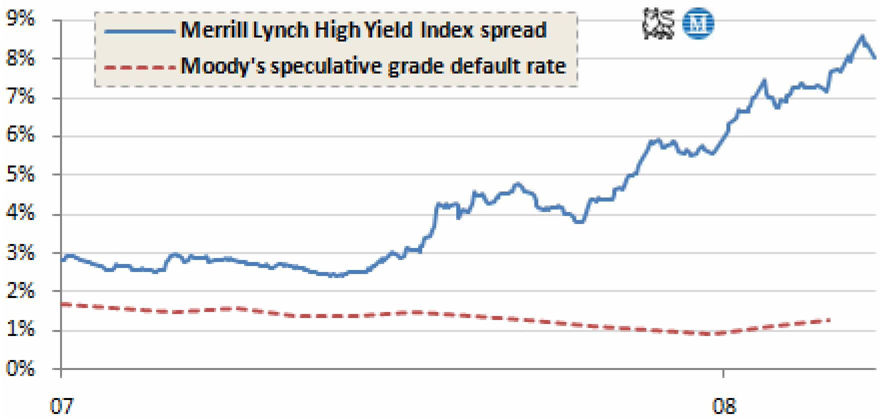
True, none of these signals in markets definitively reverses the major trends that have been in place for some time. For example, gold's dramatic drop of more than $125 from its high at $1030 nine days ago, just after the JP Morgan/Chase takeover of Bear Stearns at $2 was first announced, only takes it back to where it was trading just last month. Yet these signals are very strong hints -- gold's drop was a 4.5-standard deviation move. And they do not come in a vacuum. They are a response to a major development -- indeed an historic one -- in Fed policy. So we interpret these signals from markets as telling us the following. First, markets believe that the array of new liquidity facilities and risk subsidies designed to deal directly with the demands of the banking system will succeed. Second, with those demands satisfied, for the first time since the onset of the credit crisis markets will stop bullying the Fed into further and further rate cuts. Third, with the Fed deploying new tools -- which, when used, can be sterilized -- and with a rate-cutting cycle that can now hit bottom more quickly and reverse sooner, the Fed's rescue of the banking system will not have as high an inflationary cost as expected just days ago.

With all this confirmation of our initial caution immediately following the FOMC's decision last Tuesday, we are going to neutral on the energy sector, the materials sector, gold, oil, commodities and the dollar short. We do not mean to imply that we think inflation is no longer an issue for the economy; it remains an issue, and we will discuss that in another report this week. But from a sector investment perspective, that doesn't matter. The continued out-performance of the inflation plays depends on the continued rise of inflation expectations. Concerns about inflation may increase in the coming months as the lagged effects of the Fed's already committed policy excesses roll through the general economy and show up increasingly in official statistics. That's why we are not going to outright negative on the inflation plays. But with the worst-case inflationary train-wreck now seemingly off the table, we can no longer expect the same kind of superior performance we've seen from the inflation plays during a period when inflation expectations were almost always worsening.

Total return	*10/9/2002 to 3/18/2008*
S&P 500	+89.4%
Energy sector	+276.9%
Materials sector	+186.2%
Gold	+206.8%
Oil	+273.7%
Trade-weighted dollar	-33.4%

It saddens us a bit to make this call, having been such strong advocates of inflation plays for so many years, and having that advocacy pay off so strongly for our clients. Starting at the bottom of the last bear market in October 2002 -- when the Fed started gearing up to reflate the economy out of the deflationary consequences of its attack on "irrational exuberance" -- the inflation plays have been the best and most consistent performers. Industrial commodities such as oil, and the resource sectors -- energy and basic materials -- have also been growth plays during this time, benefiting from strong global growth especially in emerging economies such as China and India. While we believe the inflation driver of these sectors is significantly weakening now, we think the growth driver remains in place. In fact, the growth driver is enhanced by the weakening of the inflation driver. Until last week, the Fed was headed toward an extremely serious inflation outbreak, one which would eventually require a draconian and growth-limiting response in order to contain. The Fed will still have to respond in some degree to the inflation it has already unleashed -- and will continue to unleash -- from its present very easy posture. But that response will be less growth-limiting than the one that would have inevitably been required had the Fed continued to bow to market demands for further and further cuts in the funds rate.

Our call that the worst-case inflation scenario is off the table is intertwined with our belief that the Fed has now deployed tools that can limit the worst-case systemic risks arising from the credit crisis. That's not to say that, suddenly, all fallout from the busted housing boom or the burst credit bubble will go away, anymore than we think that inflation will suddenly go away. But if the Fed has indeed found a way to constrain the credit market's problems in a way that halts the panic-driven vicious circle of forced deleveraging, then it's time to capture the value in asset classes that have been the collateral damage -- pun intended -- of the credit crisis, those that have been beaten down beyond all relationship to their fundamentals by forced liquidations.



For example, corporate high yield spreads have been driven to near historic highs as the market for leveraged loans seized up. Yet the underlying default rate in the corporate universe is near historic lows. Typically high yield spreads track default rates quite closely and synchronously, so today's liquidity-driven disconnect is almost a value arbitrage. You don't need to believe that default rates will rise. We actually believe they won't rise much, at least not anywhere near commensurably to current spreads. But they could rise significantly, and you'd still likely earn a risk premium much greater than that historically offered in this market. A similar opportunity exists in stocks, with a near-historic equity risk premium when consensus forward earnings, outside the financial sector, are within basis points of all-time highs.

BOTTOM LINE: Following last week's caution, we are going to neutral on the "inflation plays," and moving off our long-standing and very profitable positive view. With financial system meltdown averted and less inflationary tools now in the hands of the Fed, the worst-case inflation scenario is off the table. These are growth plays as well as inflation plays, and the reduction of inflation risk raises the present value of long-term growth prospects. But for the near term, the major driver of their recent momentum -- inflation expectations -- has been significantly reduced. Stocks (still impounding a near-record equity risk premium) and non-exotic debt instruments (driven to firesale prices in forced de-leveraging liquidations) are way out of whack with strong underlying corporate fundamentals. Last week's near-death experience should be a durable bottom in equities, junk bonds, leveraged loans, muni's and closed-end muni funds. As to the financial sector, with systemic risk averted by the Fed's new tools, the worst has probably been seen. But after such sharp recovery in the last week, the easy money is out of the trade. It makes more sense now to be a direct creditor in beaten-down debt markets, rather than an equity holder in still troubled credit intermediaries.