

Inflation fears create buying opportunities

Just a week after intoxicating new highs, the US market has taken a turn downhill. It looks like the old stock market adage "sell in May and go away" might have been a particularly useful piece of advice to bear in mind this year.

As recent market turmoil shows, the threat of rising interest rates is rapidly making global asset markets much riskier places to be. The US market's week-long decline since the last rate hike on May 10 saw an aggregate fall in the Dow Jones Industrial Average (DJIA) of 437 points, or more than 3.75%, enough to scare any investor.

So, has the market reached its peak, and is it all downhill from here? Or is the downturn a temporary correction and a good buying opportunity?

Behind the market jitters is growing fear among investors that US inflation may not be as firmly under control as they had hoped. Even as most signals continue to point to a growing US economy, the prospect that the Federal Reserve might continue to raise rates has unnerved many on Wall Street.

We think that recent inflation concerns are overdone. Inflation fears will cause big Fed worries, but as the market adjusts to expectations for another interest rate increase, stocks may find a floor. Many investors are hoping that, once the Fed shows signs that it is ready to stop raising rates, the stock market will rebound.

Rates in the US are only just approaching levels appropriate for the prevailing macro environment, while rates in Europe and Asia remain low in both nominal and real terms. We therefore believe that higher rates are unlikely to prove a substantial headwind for equity markets in the remainder of 2006.

The U.S. economy is remarkably strong and buoyant, but high energy prices and rising interest rates are starting to take a toll on consumers. Consumer prices overall, largely driven by rising energy costs, are heading up at a 5.1% annual pace, up from 3.4% last year.

But the "core" consumer price index (CPI), which excludes volatile food and energy costs, also exceeded expectations by jumping 0.3% last month, placing it at the top end of the Fed's comfort zone. This is the second straight month that core prices rose more than economists had predicted, a sign that soaring oil prices have begun to affect other parts of the economy.

Meanwhile, the dollar is steadily weakening and its retreat could propel inflation since more of the US currency will be needed to purchase foreign-made goods. All this explains why indexes of consumer confidence have sagged in recent weeks, despite signs of healthy economic growth and a strong labor market.

Inflation is important to stocks because it influences just about every element that moves the market. The biggest impact is on interest rates, as rising inflation forces the Federal Reserve to push interest rates higher. Higher prices and higher interest rates boost costs for businesses and consumers alike, holding back sales and profit.

Inflation also hurts the financial underpinnings of stocks, making them less attractive, since a big piece of stock gains is eaten up by the rising cost of living. As inflation rises, the real value of a company's earnings stream falls accordingly.

The Fed has raised short-term interest rates 16 times in a row over the past two years, in a bid to choke off inflationary pressures in the economy. Higher rates, by raising the cost of borrowing, curb excessive spending by consumers and companies, helping to prevent bottlenecks in the economy and taking pressure off price increases.

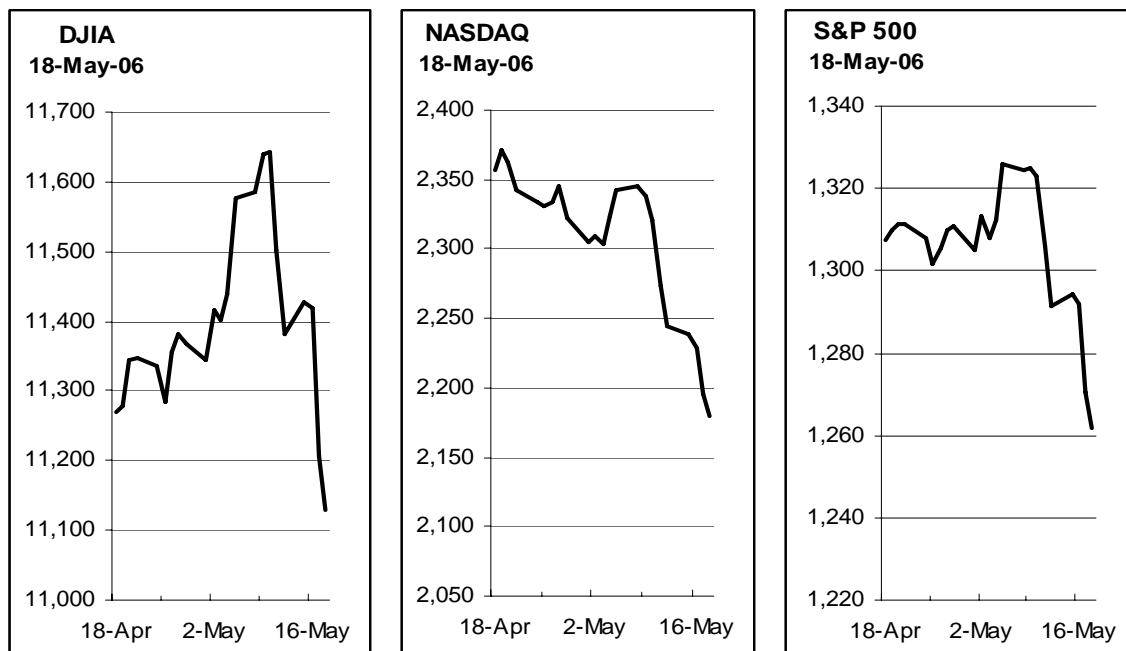
Investors had become increasingly optimistic that the Fed would pause in its cycle of rate hikes after the new Chairman Ben Bernanke said that the central bank might consider a temporary halt to allow previous rate increases to feed through into the economy.

The business press interpreted Bernanke's comments in the same way they were accustomed to with his predecessor, Alan Greenspan, and decided that "may pause" meant "very likely pause" and that "at some point" meant "June". That confidence fueled a 2006 rally which carried the DJIA to within 81 points of its best-ever close from January 2000.

But those hopes came crashing down after the Fed cautioned that soaring commodities prices posed a threat to inflation and could warrant more rate tightening. The market remains largely split on whether the Fed will increase short-term lending rates by another quarter percentage point when policymakers meet on June 29.

The only safe assumption is that there will be more volatility to come as Wall Street continues to scrutinize every new piece of economic data, looking for clues to the Fed's next move. If Bernanke keeps his forthright style, the markets will eventually figure out that he is not speaking in Greenspan code and stop overreacting so much.

Since the Federal Reserve last raised interest rates to 5% on May 10, the Dow has pulled back 4.4% and the Nasdaq has fallen 6.1%, while the S&P has shed 4.6% (based on index values as of 18/05/06).



Source: Commodity Systems, Inc. (2006)

The growing fears over inflation have affected financial markets across the globe. Falls on the London Stock Exchange have echoed across Europe as the acceleration of the eurozone core rate is likely to stoke European Central Bank fears about inflation danger.

Meanwhile, market drops in Asia have been triggered by concerns that an increase in consumer prices meant more US interest rate hikes could slow economic growth and demand for Asia's

exports.

This need not spell the end of the equity bull market. Shares are only a fraction down from their recent highs, valuations remain moderate and the economic fundamentals have not changed. With strong corporate results seasons in both the UK in March and US in April, the market still represents good value.

Furthermore, bull markets never rise in straight lines. Short-term corrections in long-term bull markets are only to be expected and create an excellent buying opportunity. The recent market unrest should settle down in a couple of months, paving the way for the return of a healthier bull market.

History suggests that some medium-term pessimism may weigh on the market in the coming months. Of the six occasions in the past four decades when the stock market indexes hit new highs, at least 5% of NYSE stocks experienced new 52-week lows within the next five days. In every case the market was lower one month later, for an average loss of 5.1%.

Energy, metals and mining stocks are currently experiencing the sharpest corrections. Oil, industrial and precious metal prices have fallen back over fears that surging prices could dampen demand.

In the short term, however, commodity consumption, particularly the demand for petroleum, is very insensitive to high prices. Economic research shows that a 10% increase in crude price only results in a 0.4% decline in consumption.

Given these stocks' recent strong performance, it is to be expected that some investors might look to lock in profits. In our view, the commodity price correction, while quite abrupt, will likely prove relatively short-lived.

The heavy falls have posed interesting questions for investors. Is the market overreacting to a possible Fed pause in June or are concerns over inflation justified?

Economists agree that it takes between 12 and 18 months for interest rate hikes to filter through to slow the economy. That is because rate hikes generally impact new investments, not projects already underway when rates go up. So it should make little difference for inflation whether the Fed moves in June or August.

It is because of this lag between policy implementation and economic effects that the Fed feels compelled to step in at the first whiff of a problem. That leads some investors to grumble that the Fed might be overreacting to a problem that doesn't yet seem very severe outside the energy world.

While the market is overreacting to fears of rising inflation, the shrewd investor should recognize that this is the time to find good values. Any fall in the market will make valuations cheaper and investment buying will take place. Investors who could not enter the markets should use this opportunity to enter solid stocks which are fundamentally strong and keep a one-year plus horizon.