

A View from the Trenches Toronto, Friday, October 30th, 2009

Good morning,

With yesterday's \$1.94BN purchase of 2013/16 Treasuries, the Fed finalized its \$300BN purchase program. If you have been following my comments since April, you will know I never thought this program would come to an end. In fact, I can't accept it has, given that nothing has improved on the fiscal side. Thus, the big question now is how 2010 will be financed. Not that these \$300BN would solve the problem, since this is not a significant figure on a relative basis, but it surely helps. From the other side, the policy side, I guess everyone by now agrees that this program did nothing else but contribute to inject liquidity to the market.

And with this in mind and the GDP (i.e. activity) numbers released yesterday, the markets pulled back on the downtrend big time. I know some analysts disagree with my positive comment here, but to me, the reversal was important: It took place in every major market (equities, corporate credit, fixed income, foreign exchange, agency debt, energy).

During a conversation with a friend and reader yesterday morning, I was asked what my view was on inflation and whether or not equities would work as an appropriate inflation hedge. I bring this issue up today, because it is gaining some popularity lately. My answer was that yes, equities are a hedge and that in fact, they have **already** hedged you against inflation. How so?

Inflation is not a reading on the CPI. It is not a jump in a price index. It is not directly related with the level of activity, as everybody wants us to believe. Inflation is a process in which relative prices of assets change, driven by an exogenous demand that had not existed until this process started, a demand that was ignited by a central bank through the purchase of securities. When the relative price distortion affects a market in particular, and it does, people speak of asset bubbles. From then on, the changes in relative prices take a life of their own, until they reach consumption goods. This may take years, but before then, stocks see their prices increase a whole lot earlier.

For instance, in 2009, one could reasonably track the relative price distortions as follows:

1. Central banks bought agency debt, mortgages = the spread of these securities vs. Treasuries compressed to the extent that investors had to shift their moneys to corporate debt, to reach for yield
2. Corporate credit spreads compressed, facilitating the refinancing of short-term debt for longer-term debt. The process boosted equity valuations (because equity is the call option on the firm's assets).
3. The process regenerated the net wealth effect (a.k.a. Pigou effect), stopping the bleeding in housing prices and commodities
4. Going forward, if the virtuous cycle continues, capital expenditures should pick up, increasing production costs.
5. If the demand remains solidly driven by monetary expansion, increasing production costs will be passed on to customers
6. Readings on the CPI (Consumer Price Index) will show inflation.

Therefore, the rally we saw in equities worldwide since March is already hedging those investors who bought and held them against the loss in purchasing power that will occur, once demand picks up to such level where companies are capable of passing on rising production costs to final customers. The rally in equities would have never taken place, had central banks not established their quantitative easing programs.

On the other hand, once these production costs are passed on to final customers, once the CPI readings show that prices are up and start driving wage increases, **it may be late to invest in stocks, if the credit expansion caused by the government was a so called "once-and-for-all exercise", as the \$300BN limited Treasury purchase.** However, stocks will keep rising in nominal value if the monetization of fiscal deficits continues at a steady speed. Under this scenario, inflation later spirals and becomes hyperinflation, as investors' expectations incorporate this constant speed of money supply. Soon, if hyperinflation takes place, stock valuations cannot keep up, because hyperinflation destroys value, but that is a conversation for another day.

The bottom line here is that if you think that central banks will begin tightening and fiscal deficits will be dealt with swiftly, the run in the S&P500 from 666 to 1,100 may be pretty much all the hedge you will get from stocks, for the upcoming inflation.

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