



Weekly Market Commentary



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Operation Reflation: How to Potentially Profit from the Fed's Intentions

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Highlights

In a surprisingly transparent statement made last week, the Fed told us that inflation is so low they are not doing enough to promote growth. To combat fears of a downward spiral of deflation the Fed is preparing a reflation strategy.

Reflation beneficiaries include precious metals, commodities, commodity-sensitive stocks, Emerging Markets, real estate, and Treasuries.

Reflation acts as a negative for the dollar and the Financial sector.

Last week, the official recession dating committee, the National Bureau of Economic Research, announced that the recession was officially over in June of 2009. This was not surprising to most market participants. In fact, the LPL Financial Current Conditions Index reflected at that time a move from contraction to growth. However, the question today that most investors want to see addressed is: will the economy slip back into recession? On that note, the Federal Reserve's (Fed) message last week implied the Fed was preparing to take action to help ensure the economy avoids a return to recession.

In a surprisingly transparent statement made last week, the Fed told us that inflation is so low they are not doing enough to promote growth. Specifically, the Fed stated, "Measures of underlying inflation are currently at levels somewhat below those the Committee judges most consistent, over the longer run, with its mandate to promote maximum employment and price stability."

The Fed balances employment and prices by seeking growth that generates the highest level of employment without causing too much price inflation. The Fed has spent much of the past 30 years determining when to attempt to slow down an economy that is growing too rapidly in order to avoid the destructive effects of high inflation. However, when inflation gets too low, as the Fed has noted it currently is, with inflation at less than 1% over the past year, it is a sign that growth needs a boost.

The Fed typically acts as a counterweight to Congress' inflationary spending impulses, but the Fed has communicated its view that inflation is too low. With Congress unlikely to pass another substantial spending package, the Fed is likely to take action.

Deflation Defined

If inflation is a bad thing, then how can inflation be too low?

Inflation results when too much money is chasing too few goods and services. This results in higher prices and usually happens when demand is strong but output is constrained in the form of shortages of materials or capacity. Deflation, or falling prices, is the opposite of inflation and generally occurs when the supply of goods rises faster than the supply of money.

The problem with deflation is that when prices fall as output exceeds demand it can become self-perpetuating as consumers and businesses postpone spending because they believe prices will fall further. Consumers



and businesses delay buying expensive items like homes or cars because they believe these things will be cheaper in the future. As a result, spending and economic growth slows, but it does not stop there. Businesses' profits weaken, straining their ability to pay their debts and leading them to cut production and workers. This, in turn, results in lower demand for goods which leads to even lower prices as a destructive downward spiral takes root.

From Deflation to Reflation

To combat fears of a downward spiral of deflation the Fed is preparing a reflation strategy. Typically, the Fed lowers the cost of money, or interest rates, when they want to promote growth. But with the Fed having already lowered rates effectively to zero, they intend to increase the supply of money by buying bonds in the market.

The Fed will likely be engaging in quantitative easing which means they will expand the supply of money in the financial system in an effort to encourage lending and economic growth. This can counter deflationary fears by directly inflating the money supply. All else equal, this means that with more dollars in the system, the value of the dollar goes down and prices in dollar terms go up, resulting in a faster pace of inflation.

The Fed took a small step in the direction of providing more stimulus at their August 10 meeting when they committed to increasing the quantity of money in the financial system by purchasing Treasuries as the housing debt they hold matures. Last week, at their September 21 meeting, the Fed paved the way for another much larger quantitative easing at an upcoming meeting later this year. The Fed may introduce a \$1 trillion Treasury purchase program at their next meeting, on November 3.

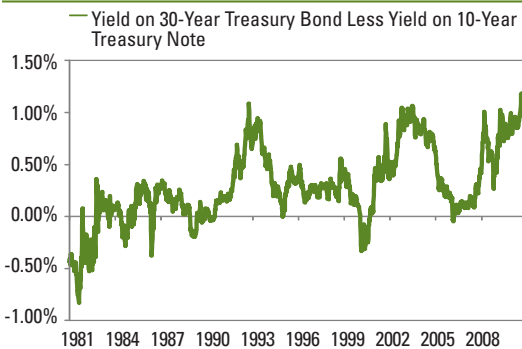
Investing for Reflation

Incorporating the theme of reflation into your portfolio may be beneficial. Key positive effects of reflation are likely to be seen in precious metals, commodities, commodity-sensitive stocks, Emerging Markets, real estate, and Treasuries. The dollar and the Financial sector may be negatively impacted.

- **Precious metals: Gold may be the most obvious beneficiary of the Fed's intentions.** Inflation and a falling dollar tend to lift gold investment demand as a way to preserve value. Gold prices made new all time highs last week. This trend can continue as the dollar falls and inflation picks up.
- **Commodities: Commodity prices—including, cotton, copper, and corn, just to name a few—may also benefit from the outlook for reflation and dollar depreciation.** Industrial and agricultural commodities posted gains on the week. The potency of the reflation theme as it related to commodities can be seen in crude oil. Crude prices were up on the week despite the report of near record-breaking U.S. inventories.
- **Commodity-Sensitive Stocks: The Fed's intention to avoid a return to recession and the potential for another liquidity-fueled rally like that of 2009 argue in favor of stock market performance.** On the



1 Near-Record Gap in Treasury Yields



Source: LPL Financial, Bloomberg 9/24/10

other hand, the effectiveness of the Fed's actions remains to be seen. With liquidity already abundant in the financial system, the inflationary consequences seem more assured than better growth prospects. Stocks gained 1% for the week following the Fed's announcement, however, stocks generally slumped shortly after the Fed's announcement on Tuesday. The gains came on Friday as stronger than expected economic data on business spending was released. Not surprisingly, the commodity-driven Materials and Energy sectors outperformed the S&P 500.

- **Emerging Markets: If the dollar weakens, gains in investments denominated in foreign currencies translate into more dollars, boosting possible returns.** Emerging Market stocks and bonds benefit from appreciating currencies relative to the dollar and the increasing value of their commodity-based output.
- **High-Yield bonds: High-Yield bonds may benefit as yield hungry investors are forced to take more credit risk to maintain yields.**
- **Real estate: Reflation benefits real estate since property prices may rise.** But to really boost Real Estate Investment Trust (REIT) performance reflation must be successful and generate better U.S. economic growth and employment, which is less assured than the inflation consequences.
- **Treasuries: Purchasing Treasuries will be the primary way the Fed implements Operation Reflation.** The price of the 10-year Treasury note rallied, pushing down the yield 10 basis points (bps) since the announcement by the Fed last week. However, while there may be additional short-term gains for Treasuries, longer-term inflation risks are increasing, as well. This risk is evident in the nearly record-breaking spread between 10- and 30-year Treasury bond yields at about 1.2 percentage points. The better economic data reported in September has pushed prices down and the yield up on the 10-year Treasury by 14bps this month while the more inflation-sensitive, longer-term 30-year Treasury yields have increased 28bps. Direct beneficiaries of reflation are TIPS, or Treasury Inflation-Protected Securities. The principal of TIPS increases with inflation.
- **Dollar: The Fed's intentions are weighing on the dollar.** As the Fed increases the quantity of dollars in the financial system the value of the dollar is likely to fall. The Fed's statement drove the dollar to its lowest level in nearly eight months. The dollar even strengthened against the euro despite news of deteriorating European economic growth and spiking Irish and Portuguese bond yields on rising default concerns. Even more impressively, the move in the dollar eroded nearly all of the start of a downtrend in the yen versus the dollar that the Bank of Japan took great efforts to create in the week before the Fed meeting. A falling dollar and rising inflation puts pressure on cash as a long-term holding.
- **Financial stocks: Bank stocks may be negatively affected by the Fed's intentions.** If 5-10 year Treasury yields move lower on Fed buying, the profit margin banks earn by borrowing short-term and lending longer-term narrows crimping profits. On the other hand, investment



banks may benefit from the additional credit to fuel profitable merger and acquisition deals and more bond underwriting as businesses look to refinance at lower rates. Nevertheless, since the Fed announcement, Financials have been the worst performing sector – the only sector to suffer losses.

Longer-Term Impact

While the near-term impacts of Operation Reflation are reasonably clear, the longer-term effects are not. Unlike during the financial crisis when liquidity was scarce, the benefits of adding more cash into the financial system on growth and employment may be very limited in the current environment given the already high cash balances at banks and corporations. In addition, U.S. stimulus cash may wind up fueling Emerging Market growth as U.S. companies deploy the cheap cash to fuel growth in markets with lower labor costs and stronger demand. The Fed also risks undermining the lower interest rates that are essential to growth by devaluing the dollar making U.S. Treasury bonds less attractive to the foreign investors that we are increasingly dependent upon to fund our national debt.

We are cautious on the longer-term economic growth impact of another round of stimulus. However, we do not believe a return to recession is the most likely outcome and believe that the economy will muddle through with below-average growth in the coming quarters. In the near-term, Operation Reflation provides us with an investment theme. And finally, though we expect near-term weakness in the stock market, the timing of the mid-term elections on November 2 and the Fed's next meeting on November 3 could help to fuel a year-end rally for stocks.

This week is light on data until Friday when the closely-watched ISM index, a barometer of the manufacturing sector of the U.S. economy, is released. But it is not until the following week that the market-moving U.S. monthly job report is released and start of the third quarter earnings season gets underway. The absence of much new news this week that would refute the pending Fed action leaves the relation theme that was established last week to continue to unfold.



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Past performance is no guarantee of future results.

The fast price swings in commodities and currencies will result in significant volatility in an investor's holdings.

Investing in foreign securities involves special additional risks. These risks include, but are not limited to, currency risk, political risk, and risk associated with varying accounting standards. Investing in emerging markets may accentuate these risks.

Risks inherent to investments in stocks include the fluctuation of dividend, loss of principal and potential liquidity of the investment in a falling market.

Investing in specialty market and sectors carry additional risks such as economic, political, or regulatory developments that may affect many or all issuers in that sector.

Investing in real estate/REITs involves special risks such as potential illiquidity and may not be suitable for all investors. There is no assurance that the investment objectives of this program will be attained.

High-Yield/Junk Bonds are not investment-grade securities, involve substantial risks, and generally should be part of the diversified portfolio of sophisticated investors.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise, are subject to availability, and change in price.

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