The Case For Inflation

A Good Opportunity For Great Stock Picking

DVM DREMAN VALUE MANAGEMENT, LLC

Confident. Committed. Contrarian.

With the country's economic outlook altogether muddied by government bond buybacks, there's a battle of ideas going on in the investment world about the inflation outlook. Indeed, people of sound mind seem to be squaring off on opposite sides of the debate. Or both. What's amazing is that these highly experienced and successful people are all looking at the same economic data.

So, here we are at the beginning of 2011 and, to say the least, there's economic confusion on the Street. But uncertainty is hardly an investment strategy, and for investors deciding how to adjust their investment portfolios - for both the short term and long term - informed conviction is everything. Everyone's is entitled to their opinion, of course, but as far as we're concerned worrying about deflation is a fool's errand. For our money, we're convinced the global economy will have to contend with inflation, maybe very high inflation. We're also confident that in this sort of environment there is great investment opportunity in equities, particularly for those who can pick the right stocks.

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Economics 101

Recognizing there are such profoundly conflicting views on the Street, it's probably worth revisiting the economic dictionary. After all, if we're to know what to do about inflation, we have to know what it is. By definition, *inflation is an increase in the money supply accompanied by an increase in prices*. Directionally, it's a fairly tangible worry - at the extreme, it's that picture of a billion-dollar bill next to a pile of Zimbabwe apples. More normally, modest inflation, or disinflation, where prices still rise but at a declining rate, marks most economic cycles. Typically, the so-called "inflationary spiral" revolves as:

- *High cost of living prompts demands for higher wages*
- *Higher wages push production costs up forcing firms to increase prices*
- *Increased costs triggers calls for fresh wage increases.*

This cycle can lock the economy into a period of rapid price increases. But - and this is a big but - governments generally know what to do about inflation. Monetary authorities raise interest rates, they rein in the money supply or, if worse comes to worst, they send the economy into a recession.

Deflation, on the other hand, *is defined as a decrease in money supply accompanied by a decrease in prices*. As cycles go, deflation is far less distinctive - falling prices aren't terribly dramatic and it's hard to visualize, much less take a picture of, money becoming more valuable. In the U.S., the last real stretch of deflation was the Great Depression. Beyond that, the most conspicuous display in recent memory would be Japan across the last decade.

The deflationary spiral, spinning figuratively opposite that of inflation, turns as:

- *Prices fall and companies earn less money*
- *Companies cut costs to remain profitable, which leads to layoffs and pay cuts*
- *Consumers who earn less spend less*
- *Borrowing dries up as spending shrinks.*

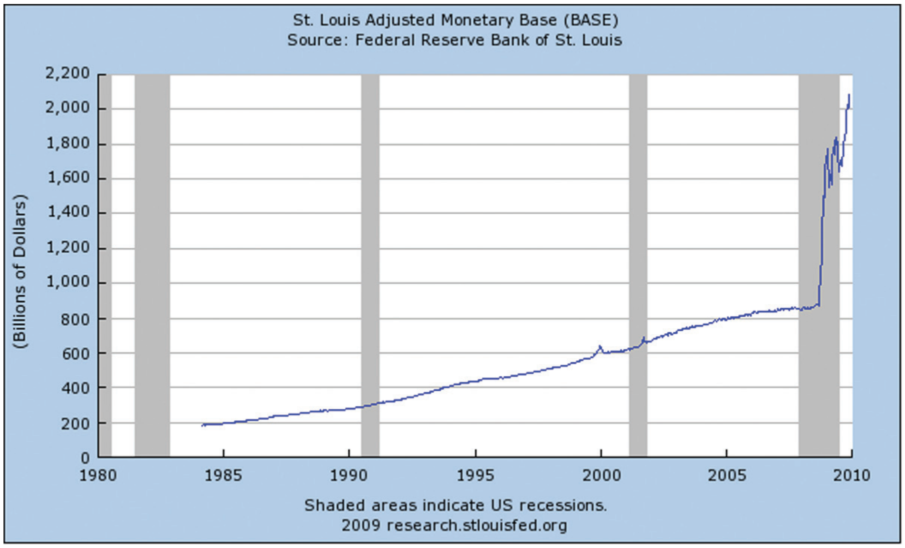
The deflationary cycle can lock the economy into *a period of economic decline* from which it is hard to escape. And on the whole, governments don't know what to do about it. Just ask Japan - increasing spending, running big deficits, and subsidizing spending all sounded good in theory, but they've collectively done nothing to solve the country's persistent deflation problem.

In a nutshell, then, *inflation is an increase in the supply of money and debt*, while *deflation is a decrease in the supply of money and debt*. But despite what you may have heard, a booming economy is not a prerequisite for inflation. And neither is a weak economic environment necessary for deflation. That billion-dollar bill next to the pile of Zimbabwe apples is proof that despite a huge output gap, surging unemployment, and a bankrupt economy, reckless 'policy makers' can succeed in creating massive inflation.

Point being that inflation is a monetary phenomenon and policy makers of a certain mind have the ability to create it.

FED OUT OF CONTROL?

In the last couple of years, the Treasury and the Fed have pumped unprecedented liquidity into the economy. Indeed, the current Fed Chairman has created three times as much money as all 13 of the prior Fed chiefs combined. And what do we have to show for it?



- *This year's budget deficit will be approximately $1.4 trillion.*
- *The budget deficit will represent 10% of the nation's GDP, a level reached only twice before in history.*
- *U.S. national debt is projected to swell to $25 trillion.*

Already, short-term interest rates are at extremely low levels, and real short-term interest rates are actually negative. If such a loose monetary policy fails to create inflation, we're willing to bet the Fed will unleash even more rounds of 'quantitative easing'. Needless to say, such a monetary-inflation will dilute the existing money stock even further and reduce the purchasing power of money.

Given the fact that deflation will increase the real value of this debt, it's easy to assume that before the U.S. government declares bankruptcy, it will desperately try to inflate its way out of trouble. If it's a choice between inflation and unemployment, the Fed has always opted for inflation, as have other major powers.

Already, economists are saying that at least one-quarter of the jobs lost in this depression will not be replaced. Worse, the Congressional Budget Office is estimating unemployment percentages to be 8.0% in 2012, 6.3% in 2013, and at least 5% through 2020. Since no government in a democratic country can stay in power introducing austerity programs during a period of high unemployment (witness the political unrest in Greece), we believe double-digit inflation is likely in three to five years.

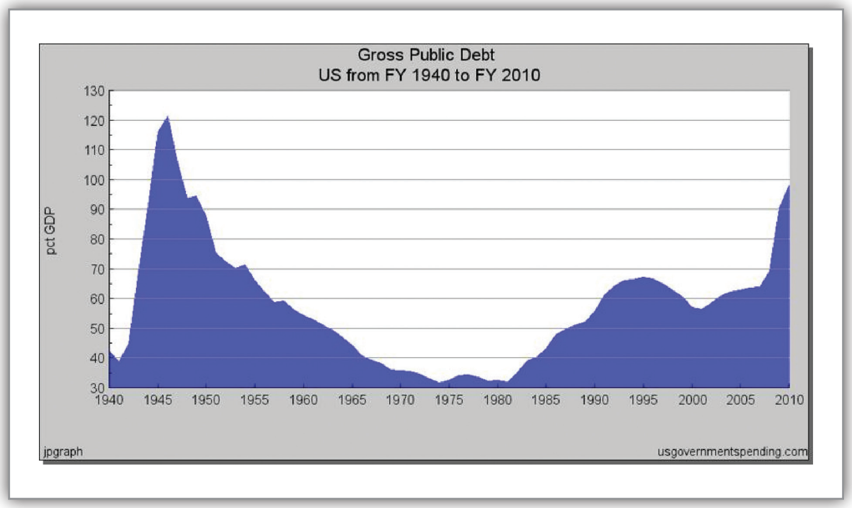
It's notable that up until now, demand for Treasuries has been strong and the Administration has not had much trouble raising money. And oddly enough, in today's volatile economic environment, U.S. government debt is still viewed as a safe haven. But every good thing comes to an end and investors' perception could change at short notice. When that happens and the bond market starts to focus on America's ballooning deficits, demand for government debt will dive. At that point, the Federal Reserve will have no option but to create new money so that it can lend it to the Treasury.

Throughout history, periods of massive money creation have always been inflationary and this time should be no different. Over the following months, if the economies of the developed world take a turn for the worse, you can be sure that the respective policy makers will respond by creating copious amounts of paper money.

Inflation vs. Deflation

At this hour, the U.S. on-balance-sheet national debt stands above $14 trillion, up a stunning 55% from an already outsized $9 trillion in just three years. (And that's not including the off-sheet debt of Social Security and Medicare/ Medicaid, which total approximately $100 trillion.)

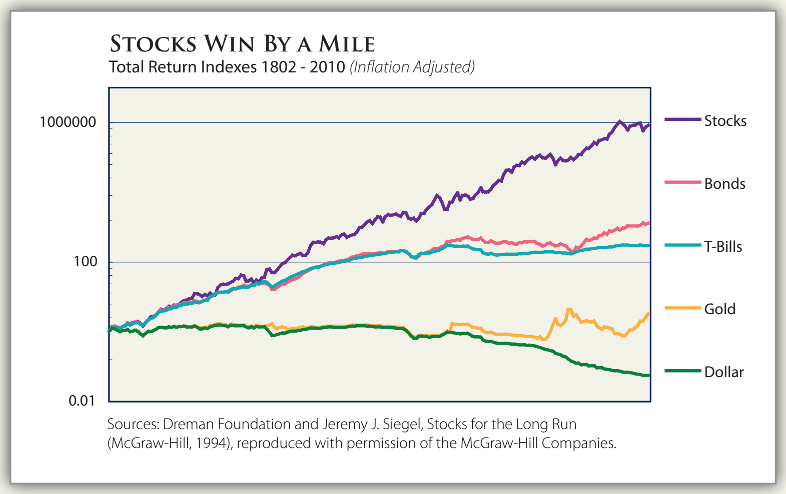
Why do these unthinkably large numbers matter? Because academic studies have shown that countries with debt-to-GDP ratios over 90% - just like the U.S. today - have not been able to grow out of their indebtedness. For our part, we believe the consequences of the recent monetary experiment here in the U.S. all but preclude anything but future inflation.



In Fact, We Think It's Already Becoming Evident

Witness, for example, the Producer Price Index (PPI), which rose 1.6% last February - that's an annual pace of nearly 20%. Worse, the index for food increased by nearly 4% in February alone, the largest one-month rise since November 1974. This follows a long-term trend that has been flashing red for some time. First gold started to rise, eventually to record highs. Then the dollar started to fall, now near record lows. Then commodity prices started to soar, with oil now comfortably at $100 a barrel.

Under supply-side economics, monetary authorities are supposed to tighten monetary policy when these inflation-sensitive market prices start to accelerate. This Fed, however, continues to print money excessively. The additional money being printed will flow somewhere, and we think the likely destination will be more outside the U.S., specifically the emerging markets, than inside. Eventually the higher growth outside the country and the associated increase in commodity prices will be exported back to the U.S. shores.



Sources: Dreman Foundation and Jeremy J. Siegel, Stocks for the Long Run (McGraw-Hill, 1994), reproduced with permission of the McGraw-Hill Companies.

Already the bond vigilantes, who have remained oddly silent in the face of all the Fed's activity, are starting to wake up. Since the Fed announced QE2, long-term rates have actually reversed and increased. We think this is a clear sign that the bond market sees inflation ahead. This is also why the inflation-adjusted bonds (TIPS) are in such big demand. In fact, the yield recently went negative for the first time since these securities came into existence.

We should remember that each outsized inflationary period in the U.S. started with a large expansion of the money supply. And, very importantly, people's willingness to hold money can change suddenly which can cause a spike in money velocity. While this transformation can happen in a few weeks or several months, it inevitably catches economists and central bankers by complete surprise as they have waited too long to drain the liquidity.

Winners and Losers

One way or the other, all of this will eat away at the value of money. In an inflationary environment, even money left in cash will shrink in value year by year. It might look the same, but it will buy less, and that's what really matters.

So, given the inflationary environment we find ourselves in, just how are investors to adjust their investment portfolios? First by recognizing that inflation will severely damage some asset classes beyond cash, most notably fixed income. In fact, it's reasonable to think that with the exception of TIPS, virtually all manner of bond will lose considerable principal value over the next few years. Viewed in that light, the ongoing strength in the government bond market may turn out to be an exceptional selling opportunity.

FREQUENCY OF STOCKS OUTPERFORMING BONDS & T-BILLS, BONDS OUTPERFORMING T-BILLS, INFLATION ADJUSTED 1802 - 2009

Holding Portfolio for…		Stocks Beat Bonds	Stocks Beat T-bills	Bonds Beat T-bills
1 Year	1802-1870	63.8%	59.4%	44.9%
	1871-1945	57.3%	61.3%	58.7%
	1946-2009	62.5%	67.2%	48.4%
2 Years	1802-1870	63.8%	59.4%	42.0%
	1871-1945	60.0%	62.7%	65.3%
	1946-2009	66.7%	73.0%	58.7%
5 Years	1802-1870	65.2%	69.6%	40.6%
	1871-1945	65.3%	69.3%	69.3%
	1946-2009	75.0%	75.0%	60.0%
10 Years	1802-1870	78.3%	75.4%	40.6%
	1871-1945	80.0%	85.3%	76.0%
	1946-2009	85.5%	83.6%	47.3%
20 Years	1802-1870	87.0%	87.0%	30.4%
	1871-1945	92.0%	98.7%	74.7%
	1946-2009	97.8%	100.0%	48.9%
30 Years	1802-1870	98.6%	92.8%	17.4%
	1871-1945	97.3%	100.0%	76.0%
	1946-2009	100.0%	100.0%	48.6%

Source: Copyright © David Dreman, 2010. Data Source: Jeremy Siegel and Ibbotson® SBBI® Classic Yearbook 2010

Conversely, the same forces that penalize cash and fixed income will favor equities. Indeed, we're willing to suggest that certain U.S. stocks, specifically those featuring a sizable dividend yield, will provide ample opportunity for stellar returns in the coming inflationary environment. Here's why: between January 1926 and December 2006, 41% of the S&P 500's total return was derived from dividends. And thanks to our current recession, the current dividend yield on the S&P 500 is close to the historical average inflation rate. In other words, even if you buy into an index fund, you stand a good chance of offsetting much or all of the inflation coming our way.

Even better is the opportunity in individual stocks, with plenty of well-known names offering dividend yields well above 3%. For instance:

Company	Dividend Yield
Altria (NYSE: MO)	6.9%
Astra Zeneca (NYSE: AZN)	5.3%
AT&T (NYSE: T)	6.1%

Beyond dividends, stocks offer an additional hedge against inflation: companies, when faced with rising costs of materials or other inputs, can simply hike the prices they charge their customers. As a result, the stocks of these companies become a participant in the nation's inflation rather than a victim of it.

As for the old standby list of inflation-sensitive investments, specifically gold, which has nearly quadrupled over the past 10 years, and commodities, where many food and energy related issues have already skyrocketed, we're of a mind to think their historical link with inflation may be broken. Besides these issues' big price run-up in an environment of almost no inflation, demand now seems to be more driven by macroeconomic factors and long-range supply concerns.

Conclusion

In many ways, the current Fed policies are a throwback to the 1970's, and as such they were bound to produce similar results. By all appearance, not least of which the PPI, those results are now here.

We believe that it is strongly evident that the unprecedented liquidity growth in the U.S. will end up producing even more robust inflation. In fact, we think it's unquestionable that inflation is in our future for some time. But from where we sit, it's just as certain that a portfolio of great companies will protect an investment portfolio from the challenges to come.

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