Equity Investing

By: R. Stewart Eads, CFA

President

Eads & Heald Investment Counsel

www.EadsHeald.com

Chapter 12: Inflation Momentum and Stock Market Returns

We have developed a simple methodology for looking at the trend in Consumer Price Inflation free from the year-to-year ups and downs. The focus is on determining when the long-term trend in inflation has reached a major top or a major bottom. Ideally, there should be no false indicators along the way. The top portion of Chart 1 displays what can be called Inflation Momentum.

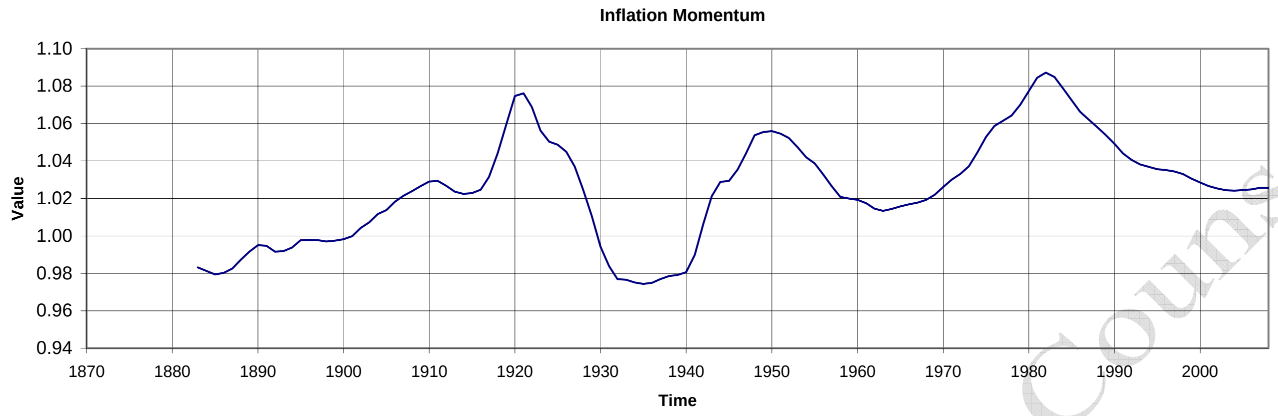
It is useful and interesting to concurrently look at the total return (price change and dividends) on the Standard & Poor's 500 stock index for running 10 year periods. The bottom portion of Chart 1 displays this. Note that this chart shows the return for the following 10 years. For example, the point at 1998 is the total average annual return from the end of 1998 through 2008

The long-term average annual total return on the S&P 500 has been approximately 10% per year. However, note in Chart 1 that very little time is actually spent at this 10% average. Returns range from down near 0% up to 20% over 10 year time periods.

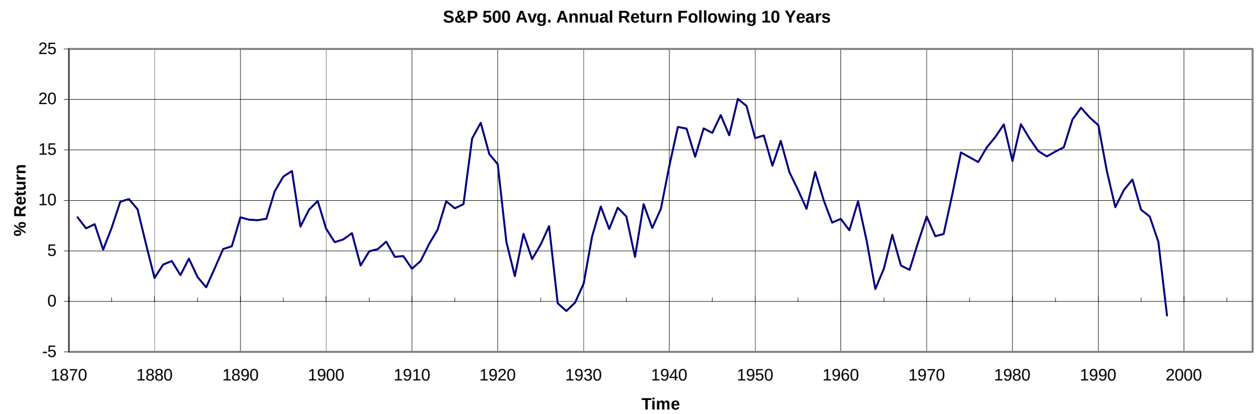
In comparing inflation momentum to stock returns in Chart 1, it is readily seen that a major top in inflation is followed by good long-term S&P 500 returns while a major bottom in inflation is followed by poor long-term returns. This makes intuitive sense if you accept inflation as the primary discount mechanism in bringing future earnings back to present value. While rising inflation boosts earnings growth to varying degrees (depending on the industry), it also squashes price/earnings (PE) multiples. This is a result of future earnings having lower present value in a period of higher inflation. The net result is negative for stock prices.

There has been a major bottom in Inflation Momentum within the past few years. This is because our political/economic system is such that it makes it difficult to be vigilant over what was seen as a non-problem -- inflation. The Federal Reserve Board is currently more concerned about promoting economic growth than with staving off future inflation. The current low valuation for the U.S. dollar will tend to increase inflationary pressures via imports. Also, the fact that inflation has been so low for so long make that a tough act to follow. In other words, a continuation of very low inflation will be difficult to perpetuate. Since inflation momentum has bottomed, it is very likely that the following 10 years will generally be very frustrating for equity investors (certainly for owners of S&P 500 index funds). Value stocks will respond somewhat differently than growth stocks to the changes. It will be very important to have a solid understanding of how these two distinct equity investment styles (growth and value) respond to changes in the trend of inflation. Also, the time lags involved are very important as to how they affect growth stocks versus value stocks.

Chart 1



Inflation Momentum
Value
1.10
1.08
1.06
1.04
1.02
1.00
0.98
0.96
0.94
1870
1880
1890
1900
1910
1920
1930
1940
1950
1960
1970
1980
1990
2000
Time



S&P 500 Avg. Annual Return Following 10 Years
% Return
25
20
15
10
5
0
-5
1870
1880
1890
1900
1910
1920
1930
1940
1950
1960
1970
1980
1990
2000
Time