Beacon Trust

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Tactics That Beat When Inflation's In Retreat

By Alan Segars, Chief Investment Officer

One of the great non events of the past few years has been the absence of inflationary pressures in the US and global markets. To the contrary, disinflation, which means prices go up at a slower clip, has been the norm in many developed regions such as the US and eurozone. Japan is attempting to emerge from a several decades bout with deflation, or the outright decline in price levels. Disinflation is particularly perplexing to some given massive monetary ease in reaction to the financial crisis and Great Recession. So why does this matter? As the economic cycle matures and the stock market gets further extended, stock selection takes on increased significance as the rising market tide lifts fewer boats. As such, portfolio construction can benefit by using the lens of factors and themes. We have introduced several of these in prior communications, such as valuation, quality, size, business investment, housing, and defense. **To this list we currently add disinflation as a tactical theme to generate alpha (excess return) through stock selection.** The reason we consider disinflation a tactical (versus strategic) theme is that it may persist for only a year or so. The bullish camp on inflation believes it has been muted by a few temporary influences. Our analysis suggests that disinflation will not only last a bit longer but will actually intensify. In other words, the inflation rate could be lower at year-end than it is today.

The Federal Reserve Bank targets core inflation, which excludes food and energy prices, at 2%. The Fed's favorite measure of core inflation is the Personal Consumption Expenditure Deflator measured year-over-year. During the first quarter of 2012, this indicator averaged 2.4% but has dropped consistently to 0.9% in February of this year, or the lowest level since October 2009. Please see chart on the next page for disinflation inflection point in 1Q2012 and subsequent S&P 500 price trend. In our view, the main driver of this trend has been spare capacity, which arises when output falls short of its potential (output gap). This condition is likely to continue for a while longer. In addition, emerging market currency depreciation should result in the US importing disinflation. The net result could be additional downward pressure on US price levels.

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Market Facts

1) Core inflation in the US is the lowest since October 2009.
2) Inflation in the eurozone is the lowest since November 2009.
3) Inflation is running significantly below targets of the Federal Reserve Bank and European Central Bank.

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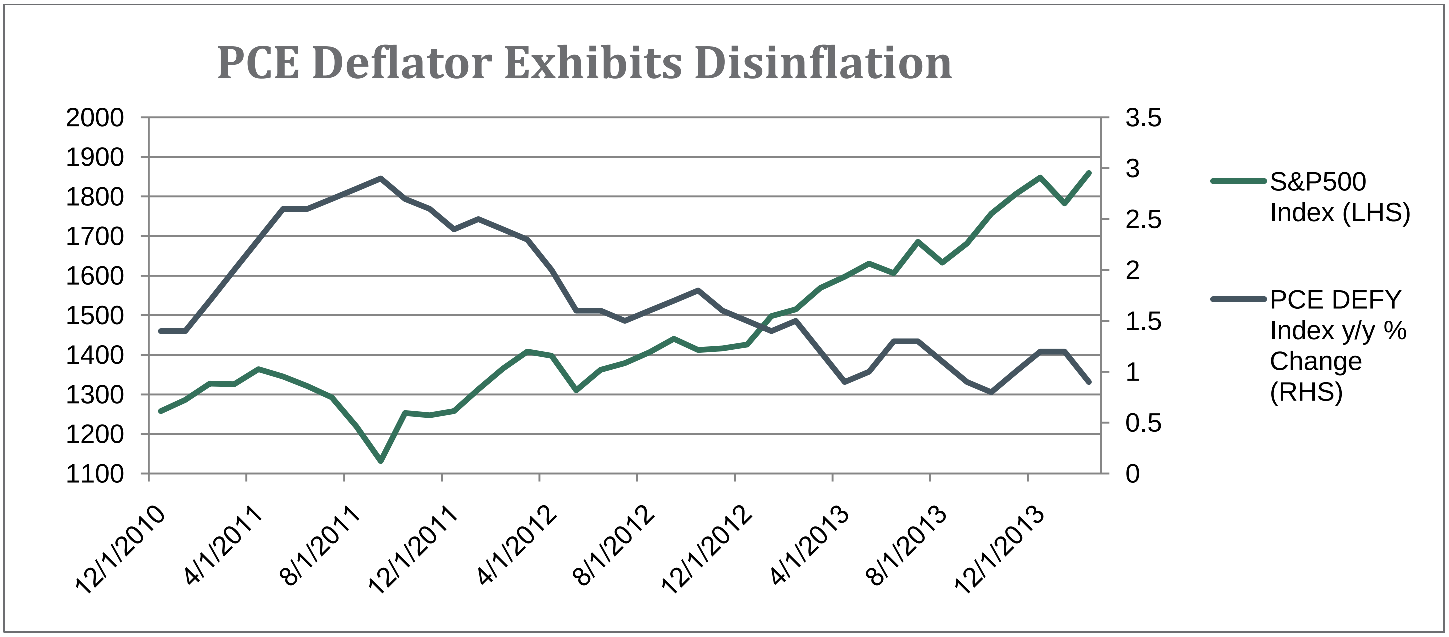

Source: Bureau of Economic Analysis; Beacon Trust

A similar and more serious situation exists in the eurozone. Preliminary inflation for March reached 0.5% year-over-year, or the lowest rate since November 2009. Euro prices are being impacted by weak demand and a strong currency. The European Central Bank (ECB) has been late to the quantitative easing party, and stimulus is actually being withdrawn. The result is a strong euro which allows for cheaper imports. Disinflation is likely to intensify in the eurozone as well. Five eurozone countries have experienced a whiff of deflation, which is possible but not probable for the entire area. As an important US trading partner, there could be a reinforcing effect as prices between the two regions are nearly 60% correlated.

Inflation is slowing in China, the second largest country. Japan, the world's third largest country, has raised core inflation to 1.5% through the year-long Abenomics program, but it is not likely to accelerate further in the absence of more stimulus Both countries are major trading partners with the US.

To the extent disinflation is likely to continue in much of the developed world, we look for stocks that benefit from this theme. A starting point is to screen for stocks that rank high (top quartile) on factors favored by disinflation. **One such alpha-generating factor during periods of falling inflation is free cash flow yield.** We combined free cash flow yield with earnings yield, a valuation factor, to back-test a basket of stocks. Since the onset of disinflation in the first quarter of 2012, this basket outperformed the S&P 500 by a cumulative 31%. Utilizing this methodology, we look for stock gems that might appreciate while the inflation rate depreciates.

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