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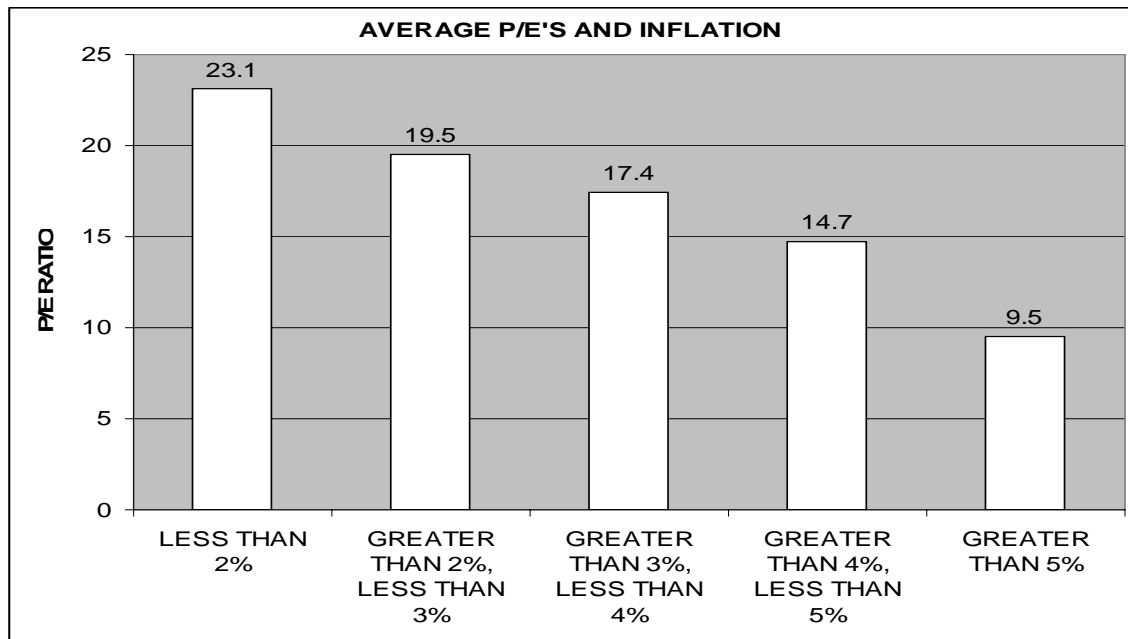
Bill O'Grady, Chief Investment Strategist

## Inflation and Equities

- Equity markets staged a rebound last week, aided by relatively firm economic data, a strong dollar rally and a sharp decline in commodity prices. On the economy, new home sales were stronger than expected, allowing the inventory-to-sales ratio to fall from 11.1 months in March to 10.6 months in April. The ratio measures how many months of current sales it would take to clear all the supply. Although an improvement, it should be noted that from 2000 to 2005 the ratio usually was five months, so it should be a while before the housing market returns to normal. The first revision to first quarter GDP rose from 0.6% to 0.9%, mostly due to a narrower trade deficit. Economic growth remains weak; we believe we are probably in a recession, but, if we are, it is a rather mild one.
- The lift in the dollar suggests improving confidence in the U.S. economy. Given the dollar's persistent weakness, mere signs of stabilization should encourage foreign purchases of U.S. assets. The dollar's downtrend has lowered the price of U.S. assets to foreign buyers, but there is little incentive to make purchases as long as the downtrend is in place. The rally we are seeing, assuming it persists, should bring some foreign buying of U.S. equities.
- A key factor that has led to the rally in the dollar and the drop in commodities has been a shift in sentiment in monetary policy expectations in our view. The September Fed Fund futures contract was projecting the odds of a 1.75% Fed Funds rate at nearly 80% in mid-April. Now the odds of such a move have fallen to zero, with nearly 60% expecting steady policy and 30% forecasting a 2.25% rate, which represents an increase of 0.25%. Although we don't expect the Federal Reserve to begin raising rates that soon, the shift in expectations does show that the focus of investors is moving from concerns about the economy to worries about inflation.
- There are a number of different data series that measure inflation. The most well known is the Consumer Price Index (CPI). Although well known, this index suffers from a variety of problems, including limited ability to account for consumer substitution. For example, if beef prices rise, a consumer may buy more chicken. The CPI does not account for such substitution and can overstate inflation. Economists generally prefer the Personal Consumption Expenditure (PCE) deflator to measure prices as it better accounts for substitution. Based on this price measure, the most recent yearly change in overall inflation is +3.2% with the core rate (less food and energy) at +2.1%. Policy makers tend to focus on the latter number on the assumption that food and energy prices can rise due to uncontrollable weather factors or geopolitical events. Although it is debatable that these factors are the primary driving factor behind the current increase in energy and food, the fact remains that the overall rate tends to follow the core rate over time.
- The focus on controlling inflation is good news for investors as rapidly rising price levels tend to undermine the attractiveness of financial assets. The relationship between price/earnings ratios and inflation is the topic of this week's Chart of the Week.

*Bill O'Grady has been named Chief Investment Strategist for the combined firm, responsible for providing broad-based macro analysis of domestic, foreign and commodity markets. Since joining A.G. Edwards in 1989, he has covered the debt, foreign exchange and energy futures markets as director of Futures Research, as well as performed short-term technical analysis of equities and monitored the effect of geopolitical, political, economic and social events on the equity markets as assistant director of Market Analysis. Bill was previously the Chief Global Investment Strategist at A.G. Edwards and is frequently quoted in the major media, including the Financial Times, the Wall Street Journal, CNBC and Bloomberg.*

## Chart of the Week:



For illustrative purposes only. This does not reflect the performance of any specific investment.  
Past performance is no guarantee of future results

Sources: Haver Analytics, Commerce Department, Wachovia Securities

This chart shows the P/E ratio for the S&P 500 on a four-quarter trailing basis from 1960 through the first quarter of 2008. We segregated the P/E data based upon various levels of inflation, measured by the personal consumption deflator less food and energy. This inflation calculation has been the preferred measure of the Federal Reserve. As the chart suggests, P/Es tend to be inversely correlated with inflation. *Correlation refers to a statistical measure of how two securities/events move in relation to each other.*

Currently, core inflation is 2.1%, which means that the trailing P/E generally should average 19.5 times earnings based on the chart above. At the end of April, the trailing P/E was 25.5 times earnings, suggesting the market is somewhat overvalued. However, as we discussed in May 19, 2008 report, we expect earnings to improve in the coming quarters due to the sharp decline in unit labor costs. If this is the case, P/E ratios would likely improve as well. Thus, a well-behaved core inflation rate would allow the market to support a relatively high P/E ratio.

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