BEAR STEARNS

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David Malpass
212 272-4293
dmalpass@bear.com

Tim Kearney
212 272-5981
tkearney@bear.com

Sandy Batten
212 272-8428
sbatten@bear.com

From Reflation to Inflation: Investment Implications

We had hoped that the world economy would move straight from deflation to reflation to price stability -- a "constructive multi-year reflation process." That would optimize world growth and equity market gains. (See *From Deflation to Reflation* on February 7.)

We now think there will be an inflation phase before we achieve price stability. The value of the dollar has undergone more than a roundtrip, rising sharply after 1996, then more than erasing its gains. We don't think interest rate hikes will come soon enough to avoid an inflation problem. The sequence may look like this: **from deflation to reflation <u>to inflation</u> to price stability**.

Reflation vs. Inflation

What's the difference between inflation and reflation? To us, it's substantial both in terms of indicators and investment implications (see *Q&A on Reflation* on February 14.)

- In reflation, the value of the dollar and the inflation rate move from deflation territory to neutral (the long-term average). However, if the dollar weakens much below neutral, it causes an overshoot in the inflation rate. The dollar is now 20% weaker than its 10-year average. By this measure it's at its weakest point since 1988, which was the start of the last inflation scare. The core PCE deflator, a key measure of inflation, picked up to a 1.8% annual rate in the third quarter from a 0.8% annualized rate in the first, pointing toward an overshoot of the 2% mark.

- In reflation, interest rate increases occur as needed to keep the dollar relatively stable. The yield curve would flatten but not invert (meaning short-term interest rates would rise more than long-term rates, but would not have to go above them.) In inflation, the Fed falls behind on interest rates and dollar stability, leading eventually to an interest rate spike. At present, the combination of a weaker-than-normal dollar, a steeply upsloped yield curve and a record spate of negative real interest rates is signaling inflation and an eventual interest rate spike.

- In reflation, gold prices rise first, then commodities, then they stabilize allowing economic growth to spread. In inflation, gold and commodities both continue rising until monetary policy improves. Gold price increases have been accelerating steadily since March 2001, with commodity prices joining in.

- In reflation, shortages are rare. In inflation, they become more frequent. We note shortages across an increasing range of sectors, from ships to steel to agricultural products to the personnel, machinery, and processes which create them.

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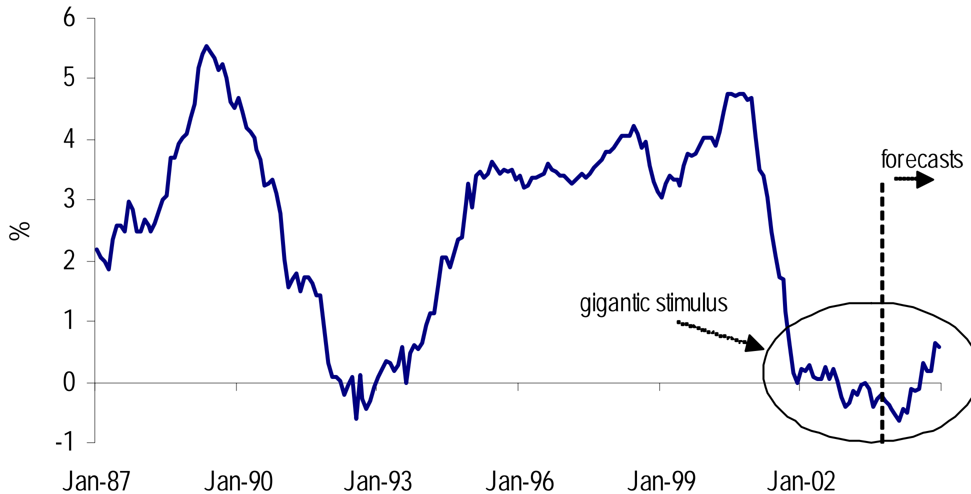
- In reflation, we expected reasonably steady, above-average growth in 2004-2006 (say 4.5% per year.) Under inflation, we expect delayed interest rate hikes to act initially as an accelerant to the economy as in 1994, then to bite into growth later in 2005. The hikes in interest rates won't slow the economy until they catch up with inflation.

Real Federal Funds Rate (Fed funds minus core PCE deflator)



Source: Haver; Bear Stearns & Co., Inc.

Investing for Inflation

Some parts of our outlook remain the same. Whether in reflation or inflation:

- Equities outperform bonds. Commodities and basic materials do well. Emerging markets do well.

- The economic expansion is sustainable, not fragile. In inflation, **the risk is more toward overheating than stalling out.**

- We disagree with the concerns about a collapse in consumption, housing, the dollar, and China's growth rate. We specifically disagree with the view that U.S. consumption growth is dependent on tax rebates and mortgage refinancings or is likely to retrench. Whether in reflation or inflation, the deficits in the current and fiscal accounts are not key issues in the outlook, though the quality of the U.S. investment climate and the expansion of the federal government are.

Some changes in view:

- By its nature, inflation causes a shortening of the investment horizon. It may add to near term profits at the expense of longer-term profits. On a relative basis, this adds to the value of existing assets (a ship) at the expense of future assets (a growth business.) **Relative to reflation, inflation favors leverage and existing capacity more than innovation and future growth.**

- We expect the profit cycle for commodities and basic materials to go further than we had thought. By the time we achieve price stability, the relative market cap weightings of major sectors may have shifted substantially toward an inflation stance (a miniature of the 1970s.) .

- An overshoot in investment in commodities and basic materials drains resources from other parts of the economy. While near-term growth should remain fast, the mix of growth is becoming sub-optimal, slowing the out-year growth potential. For example, growth in 2005 would be negatively impacted by inflation.

- Japan looks better in a U.S. inflation than in a reflation. The U.S. shift toward inflation might help Japan break its deflation spiral, offsetting the negative impact of the Dubai communiqué and supporting Japanese growth and equity gains. (See *Japan: U.S. Inflation Should Help* of November 24)

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