

Global Inflection Point?

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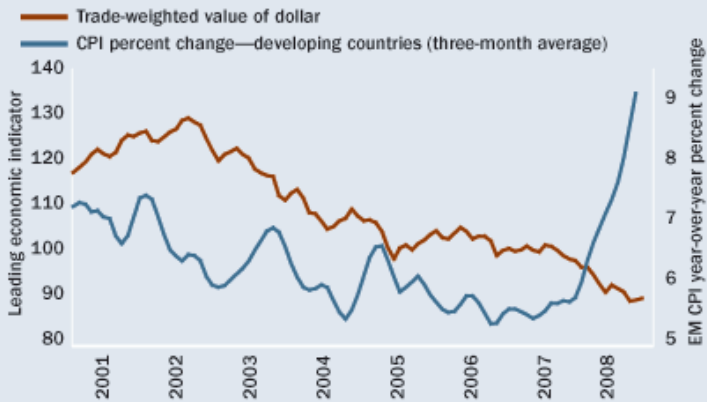
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The housing fiasco, credit market crisis, weak dollar and now significant inflationary pressures have combined to put investors on edge—and for good reason. These are formidable headwinds to the U.S. economy that could continue to weigh on stocks and bonds for some time. Investment dollars have flowed outside of the United States as many developed and emerging markets alike have outperformed U.S. markets in recent years. But \$140-plus-per-barrel oil and skyrocketing food prices are not just the United States' problems.

In fact, there are mounting signs that a global inflation problem could mark an inflection point in financial markets worldwide (see "Global Inflation Outbreak May Herald End of Dollar Decline" below). In our opinion, the likely impacts on investors would include:

- An eventual shift toward U.S. outperformance relative to international markets.
- A leadership shift within U.S. equities from industries with a global tilt to those whose fortunes are tied more directly to the U.S. economy.
- A potential rotation in emerging markets from resource providers to users.

Global Inflation Outbreak May Herald End of Dollar Decline



Source: FactSet, Commodity Research Bureau and Federal Reserve, as of July 1, 2008.

We think that the dollar and commodities hold the keys to unlock this would-be shift. While commodity-based inflation appears poised to unleash a wage-push inflation spiral around the globe—and already has in some emerging markets—we think the United States is better-equipped to keep it contained. The end result of the worldwide inflation surge is likely to be much slower global growth.

Although we don't expect the U.S. economy to be better off because of it, we do see the possibility of the dollar rallying as relatively more-optimistic investor expectations of global growth eventually wither and converge with the already dour U.S. outlook.

Global inflation drivers: oil, food and global imbalances

To be sure, the world is facing significant inflationary pressures. And as is increasingly apparent at the gas pump and corner market, oil and food prices are the obvious culprits. A lion's share of the blame has been placed on speculators (which is typical), with plenty of data supporting this claim. The outstanding value of all commodity derivatives has grown eight-fold since 2004 to nearly \$8 trillion, while commodity index fund investment has taken a major share of open interest in various commodity futures markets—60% in the case of wheat futures.

But rarely do market bubbles form without real fundamental drivers as a catalyst. In the case of crude oil, global demand has outstripped supply growth for years. Developed-economy demand growth has slowed from a long-term average of 3.2% to -1.4% last year. But it's no secret that emerging economies have more than made up the difference, now accounting for a record 42.7% of total global demand for oil.

According to the Organisation for Economic Co-operation and Development (OECD), oil demand from developing economies has been growing at 3.9% on average, with China's demand growth vacillating between 7% and 8% per year.

Meanwhile, oil-supply growth (which had been averaging 1.4% per year) slowed

to near zero during the past two years. While on-hand inventories remain ample, the market has apparently extrapolated supply and demand trends well into the future, as often happens in burgeoning economic bubbles. When geopolitical risks are added into the equation, and with Iran—the world's fourth-largest oil exporter—potentially in Israel's gun sights, the timing of a top in oil prices becomes even more uncertain.

Food prices, which have already been boosted in recent years by a growing demand in wealthier emerging markets, are being aggravated by higher energy-related production and transportation costs. Biofuel mandates only exacerbate the direct transfer of higher energy prices into food prices. And supply disruptions, whether from flooding in the United States or temporary bans on rice exports in Asia, only add fuel to the fire.

But ultimately, "too much money chasing too few goods" is the root cause of the global inflation outbreak (to quote the late, great Milton Friedman). And the Federal Reserve is not entirely to blame. Much of the excess liquidity can be traced to global imbalances (such as excess U.S. spending and debt, and excess saving and investment in many emerging markets). These imbalances relate to technology-spurred globalization. But rampant currency manipulation—particularly by China—has likely supercharged them.

Meanwhile, the deflationary impulses from cheap imports resulted in offsetting declines in U.S. interest rates and the dollar—in a sense, importing liquidity into the U.S. economy. And the rapid accumulation of savings, foreign direct investment and artificially low currency values (predominantly in emerging markets) led to very strong economic growth abroad.

Alas, this led to demand for commodities outstripping supply—and to inflation. But because of these imbalances, not all inflation is created equal. The United States faces different inflation challenges than most other countries—and the dollar could come out ahead of other currencies because of it.

U.S. inflation: relatively controlled

In the United States, inflation can be most clearly traced to the weak dollar, which has fallen nearly 30% since 2002 on a trade-weighted basis. And a weaker dollar makes world-priced commodities even more expensive.

In June, import prices rose nearly 21% from the prior year. Even when we exclude petroleum, the impact of the weak dollar is evident, with import prices rising more than 7%. And there's no longer a deflationary impact from Chinese imports, with the latest data showing that prices rose nearly 5% from a year ago.

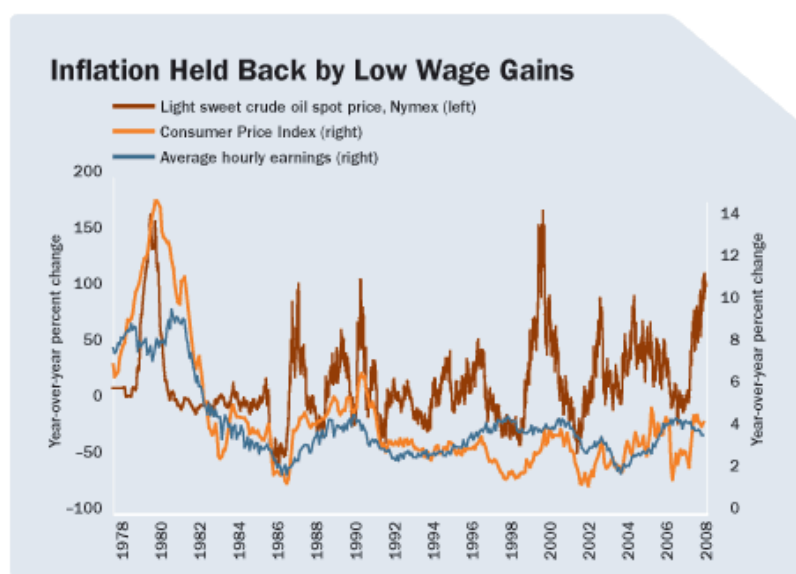
These are alarming trends, to be sure. But we believe that the United States is positioned to cope with high import prices. Even with aggressive Fed interest-rate cuts (from 5.25% last August down to 2.0% now), we believe overall inflation, running at 4.1% (2.3% excluding food and energy) year-over-year, will likely ease in the coming months. The reasons:

- Housing is still in the trenches. Until excessive inventories decline, home prices are likely to keep falling.
- Businesses are on their heels. Though nonfinancial companies generally have strong balance sheets and are not rapidly firing workers, they're not hiring either.

- Deleveraging continues. While the financial system is back from the edge of the abyss seen in March, significant problems persist. Lending standards are likely to remain high, and credit availability relatively scarce.

Bottom line: The U.S. consumer is stretched and will likely remain under significant pressure, particularly as spending on essential items has risen to a record 56% due to increasing food and energy costs. In this environment, wage growth—which has the primary influence on U.S. consumer prices—is likely to stay tame as long as inflation expectations remain tethered.

In fact, the Fed has telegraphed that as long as these important components of overall inflation remain well-anchored, it, too, believes inflation will remain under control. While some consumer survey reports reflect rising short-term inflation expectations, market-based measures favored by the Fed remain stable. As "Inflation Held Back by Low Wage Gains" illustrates, the soft trend in wage growth is a key difference between now and the late 1970s, when wages spiraled upward.



Source: FactSet, Reuters and U.S. Department of Labor, as of July 1, 2008.

As for import inflation, that will be determined by the value of the dollar and the trajectory of commodity prices. Continued strong gains in import inflation pose significant risk to well-anchored wages and inflation expectations. But we expect the relatively worse inflation landscape around the globe to work toward slowing global growth, which could help bring commodity prices down and stabilize (or even boost) the dollar.

Why the dollar could rally

In recent quarters, the U.S. slowdown in economic growth, the financial crisis and relatively low real interest rates have accelerated the now six-year decline in the dollar, as growth around the globe remained relatively robust (and absolutely strong in emerging markets). But there may be an increasing possibility of a shift in currency performance, due in part to the growing global inflation problem that will likely result in much slower growth worldwide (see "Dollar Does Better When Global Growth Suffers").



Source: FactSet, OECD and Federal Reserve, as of July 1, 2008.

Wage inflation stands a better chance of taking root outside of the United States—and not only in emerging markets. The percentage of the workforce that is unionized in Germany (22%) and the United Kingdom (29%) is relatively high when compared to the United States (12%), thus providing labor with collective bargaining power to help keep wage gains on pace with energy inflation.

U.K. wage inflation remains sticky (near 4% year-over-year amid a still very tight labor market) while in the European Union (EU) it's currently at 3.3%—near the same level as in the United States, but trending higher in the EU versus a downward trend in the United States. This wage growth contributes to the European Central Bank's heavy focus on inflation, and could result in further rate hikes—despite growing risks of more substantive bank losses relative to the United States possibly still looming.

To us, this sets up the potential for a pullback in the euro versus the U.S. dollar as an EU growth slowdown eventually trumps inflation concerns. And the British pound appears poised to break a long-term uptrend versus the dollar amid ebbing economic sentiment and rising inflationary pressures.

China's currency, the yuan, is likely to continue to appreciate versus the U.S. dollar at a controlled rate to help fight inflation (currently about 8%, versus just 2% as recently as 2006). Policymakers in China have opted to use currency strength and higher reserve requirements rather than higher interest rates to try to slow down economic growth.

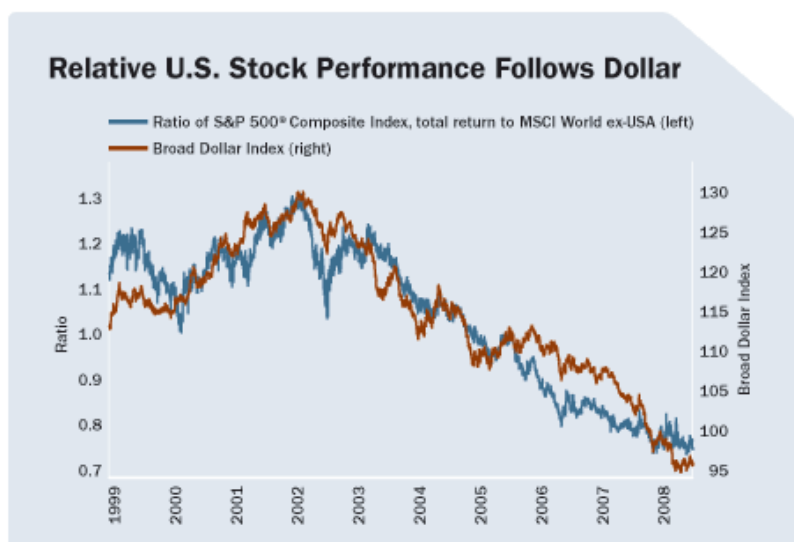
However, commodity inflation is impacting many emerging countries amid a continued flood of investment capital, and wage-push inflation is also now prevalent in Russia (Consumer Price Index +15%), India (wholesale prices +11%) and, to some extent, Brazil (CPI +5.6%)—forcing many central banks to raise interest rates.

While most of the commodity currencies (like the Canadian dollar and Brazilian real) have held up along with oil prices so far, the secondary impact of higher

global interest rates and embedded wage inflation on the economic growth prospects likely have not been priced into their currencies. A decline in Asian equities and other leading economic indicators—as we've seen in recent months—has, in the past, led to significant declines in commodity prices and related currencies.

Investment implications

U.S. stocks still face considerable headwinds, particularly if global growth continues to slow, hurting U.S. exports. But as "Relative U.S. Stock Performance Follows Dollar" illustrates, the trend in the U.S. dollar has historically been a key factor in determining U.S. stock performance relative to international. Many institutional investors are now looking to decrease European exposure in favor of U.S. markets. A sustained dollar rally would likely bolster this shift toward U.S. stocks.



Source: FactSet, Federal Reserve, MSCI and Standard & Poor's, as of July 1, 2008.

Additionally, we wouldn't be surprised to see a shift out of resource-providing emerging markets and into already beaten-down Asian emerging markets (resource users) if an inflation-spurred global growth slowdown can break the back of speculation and geopolitical worries and allow commodity prices to come down.

Now could be a good time to check your international and domestic equity allocations. For help with domestic equity ideas, see "What You Can Do Now" below.

What You Can Do Now

by Brad Sorensen, CFA, Director, Sector Analysis
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So what to do if you agree a shift is coming in the relative outperformance of U.S. stocks versus international, and that the beleaguered dollar might at least stabilize? If you're willing and able to make near-term tweaks to your equity portfolio, we have sector, industry and stock suggestions.

Up off the mat

At the sector level, two that have suffered a lot lately are among the most domestically focused—financials and consumer discretionary—with only about 25% and 18% of revenue, respectively, from foreign sources. Both tend to underperform when

the dollar weakens, so it wouldn't be a surprise if they start to recover a bit should the dollar stabilize. We don't recommend overweighting these sectors, but if you've avoided them, consider adding to your positions—with a slight emphasis on financials, which have the highest dollar correlation of all 10 sectors and the third-highest percentage of sales coming domestically.

Captains of industries

Looking deeper, for industries with high Schwab Industry Ratings® that are more domestically exposed and would tend to benefit from a strengthening dollar, we found four worth a closer look:

- Railroads
- Retail food chains
- Aerospace and defense
- Media

These areas of the market are less exposed to foreign sources of revenue, and therefore may receive a bit of a tailwind should the dollar strengthen and foreign economies slow—shifting investor sentiment that has heavily favored areas with greater international exposure back toward the United States. Using the Stock Screener on Schwab.com, you can generate a list of stocks rated highly by Schwab Equity Ratings® in these four industries. By tactically moving a bit of money into these areas, we believe you could benefit from the shift in sentiment we see in the making.

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