

POSITIONING FOR RISING INFLATION AND INTEREST RATES

By: William P. Zox, CFA

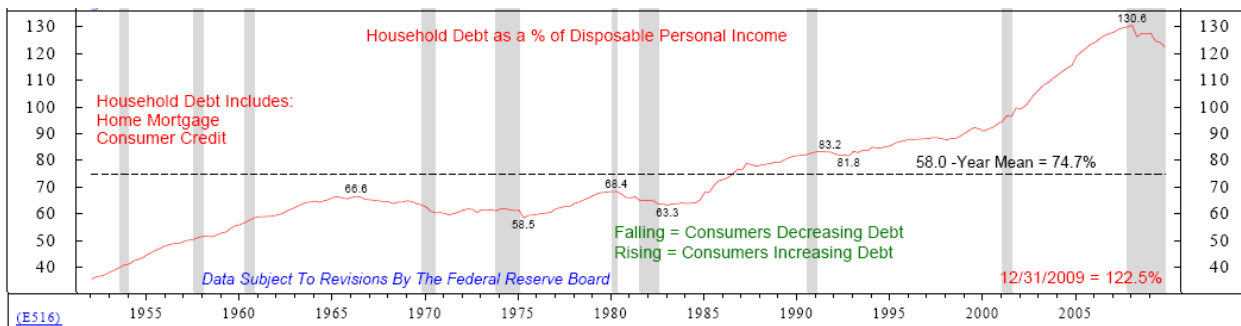
April 28, 2010

Positioning for Rising Inflation and Interest Rates

Investor concern about rising inflation and interest rates has continued to grow as the recovery in the markets and real economy has progressed. Although the timing and magnitude are difficult to predict, we believe that rising inflation and interest rates are two of the more important risks over our five-year investment horizon. The reserve currency status of the U.S. dollar and the depth and liquidity of our capital markets are once again attracting investment, as investors fret over sovereign debt concerns in the euro area. However, the U.S. debt situation could at some point lead to the same kind of pressures that have led to higher interest rates in certain euro area countries.

The crosscurrents in the markets today are striking. On the one hand, we are in the midst of a powerful rebound in the economy. On the other hand, a litany of longer term factors could restrain growth over the next five years including: (1) the U.S. consumer is in the early stages of what we expect to be a multi-year period of deleveraging (Exhibit 1), (2) higher tax rates, (3) increased government regulation, (4) excess supply of housing, (5) pressure on the budgets of state and local governments, (6) intensive fiscal austerity measures in the euro area that will inhibit growth of an important trading partner, (7) a sharp slowdown in growth in China due to a policy mistake and/or bursting asset bubbles, and (8) the possibility that the U.S. government will be forced to accelerate its balance sheet repair relative to current expectations.

Exhibit 1 – Consumer Deleveraging Still in Early Stages

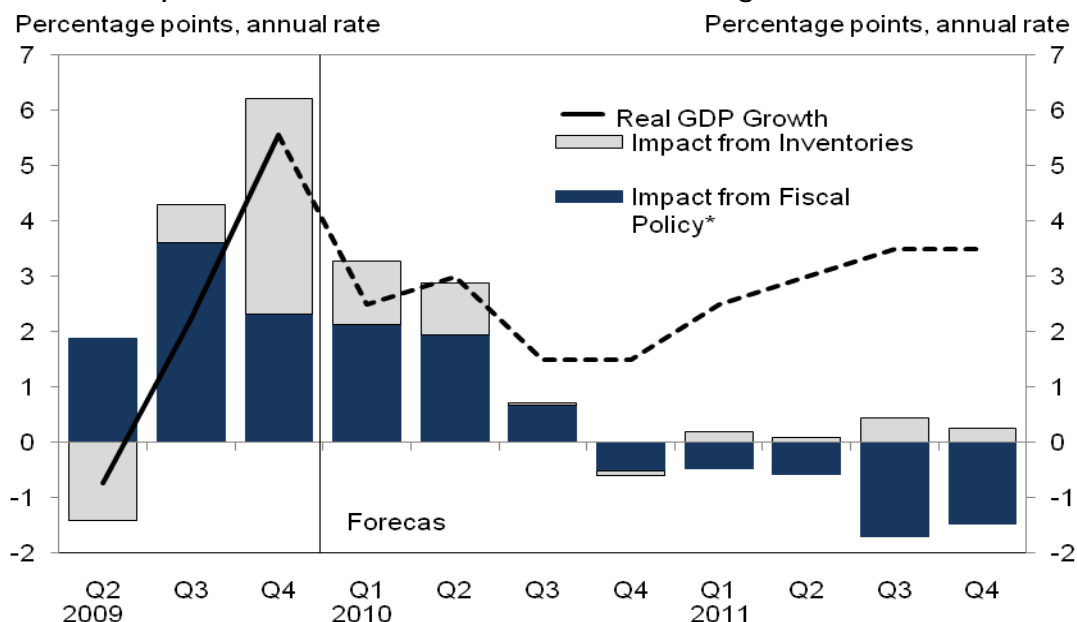


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While we believe that the longer term factors will dominate, we cannot ignore the strength of the near term economic recovery. Historic levels of monetary and fiscal stimulus led to a powerful turn in the inventory cycle. The impact of fiscal stimulus and the inventory cycle may have contributed 3 - 6 percentage points of GDP growth during each of the last three quarters (see Exhibit 2). The contribution from these factors should be nominal in the 2010 third quarter and then negative during the fourth quarter and all of 2011. This transition will be a material headwind to growth, but the virtuous cycle of production, income, and consumption growth may be taking hold this quarter, making the waning of fiscal stimulus and inventories less consequential. In this case, the economy could achieve "escape velocity" or self-sustaining growth in the near future. Since February 8, 2010, the stock and corporate bond markets seem to be discounting this view, with the S&P 500 Index up 12% and the Merrill Lynch U.S. High Yield Master II Index up 6%, since that date. In contrast, while Treasuries have

sold off, the reaction in that market has been muted. Since February 8, 2010, the 10-year Treasury yield has increased from 3.56% to 3.73%, while the 2-year Treasury yield has increased from 0.76% to 1.02%.

Exhibit 2 – Impact of Fiscal Stimulus and Inventories Waning

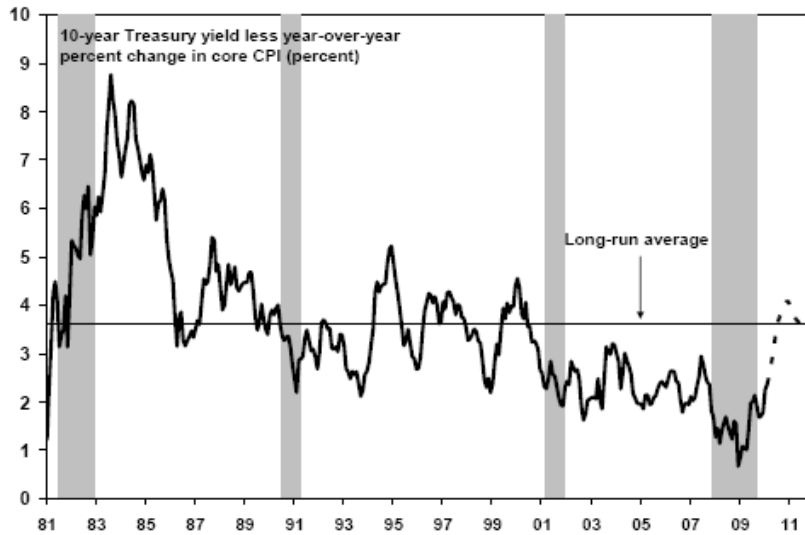


*Includes second-round (multiplier) effects on spending.
 Source: Congressional Budget Office. Recovery.gov. Goldman, Sachs & Co. calculations.

If the virtuous cycle does take hold, the next question is whether the economy can withstand higher interest rates. Within a quarter or two, it is likely that banks will be more certain about regulation and more confident in the economic recovery. To grow production, businesses will have to hire employees and invest in working capital and capital equipment. This could lead to an important inflection point where private market participants will begin to compete at the margin with the government for debt capital. The market would then likely test higher interest rates. For a time, it is possible that higher interest rates will be self-correcting, leading to another leg down in housing and business and consumer confidence. At some point, however, the economy will be better able to withstand higher interest rates.

Inflation typically lags the start of an economic recovery by about two years. Extreme levels of unemployment and excess capacity may lead to an even longer lag in this cycle, so inflation could continue to moderate even as the economy achieves escape velocity. In this case, rising interest rates would initially be a result of higher real yields, rather than higher inflation. (In simple terms, the yield of a Treasury bond can be broken down into (1) an expected future inflation rate and (2) a real yield that will grow the investor’s purchasing power and compensate the investor for various risks (e.g., unanticipated inflation, liquidity)). If our longer term concerns lead to normal real GDP growth of 2 - 3%, it is prudent to plan for real yields of 3% or so, which is still below the long-run average of 3.5% but well above today’s level (see Exhibit 3).

Exhibit 3 – Real Interest Rates Should Rise

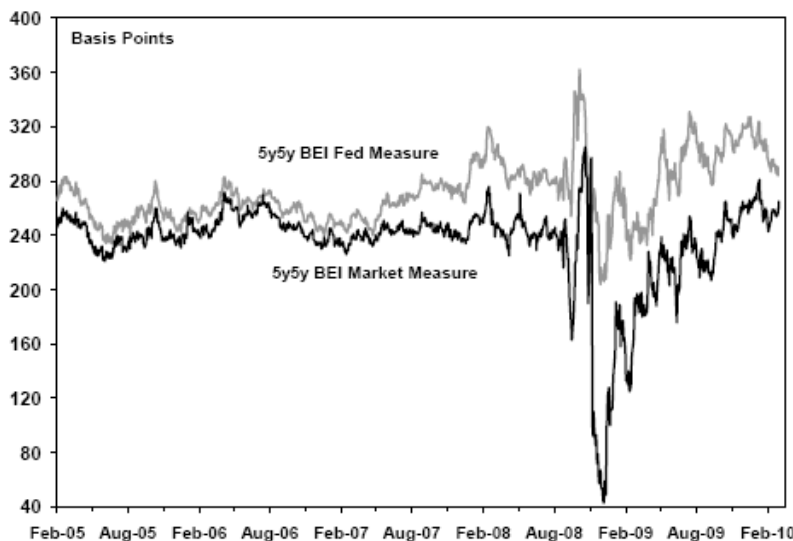


Note: March 2010-December 2011 values represent Morgan Stanley Research estimates.
Sources: Federal Reserve Board, Bureau of Labor Statistics, Morgan Stanley Research

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Market-based indicators of future inflation look past the current moderation, but they do not price inflation five years out materially higher than the range experienced over the last five years (see Exhibit 4). There are reasons why inflation may surprise to the upside. The stabilization and then reduction of U.S. debt as a percentage of GDP will probably require a combination of higher taxes, lower spending, and inflation. Higher taxes and lower spending will require far more political will than the more stealth method of inflation. Moreover, deflation only exacerbates the debt problem, and the threat of deflation makes the Federal Reserve more likely to err on the side of higher inflation. Finally, capacity destruction is difficult to measure, so it is possible that excess capacity could be overstated at any point in time.

Exhibit 4 – Forward Inflation Measures Rising



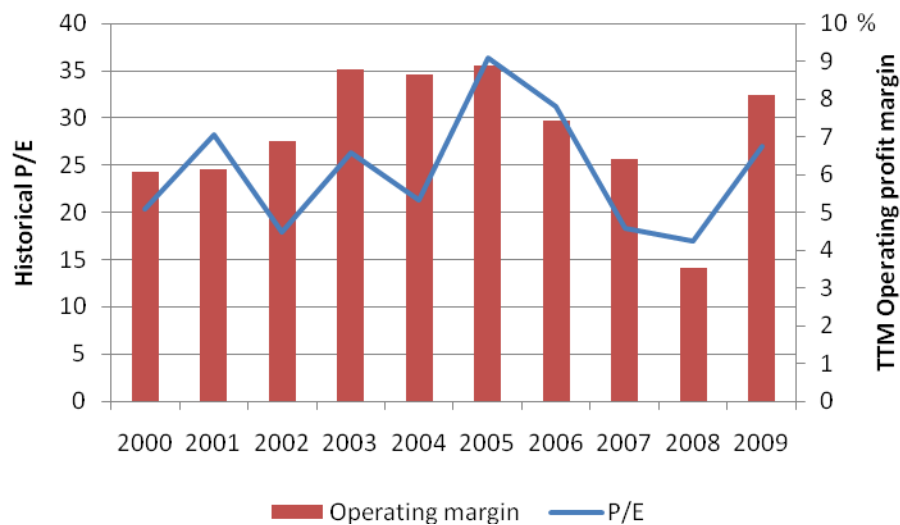
Sources: Federal Reserve Board, Macroeconomic Advisors, Haver Analytics, © 2010 Morgan Stanley

How should this macroeconomic backdrop impact portfolios? It is too simplistic to position for the possibility of rising inflation and interest rates by broadly selling bonds and buying stocks. After the tremendous rally in risk assets over the last 14 months, investors must be selective about which bonds to sell and which stocks to buy.

It is important to recognize that stocks are exposed to interest rate risk. We expect that the stocks that will suffer the most in a rising inflation and interest rate environment will have two characteristics: (1) price-to-earnings multiples that are higher than warranted as interest rates begin to rise and (2) earnings that come under pressure in an inflationary environment. In contrast, stocks that begin with reasonable price-to-earnings multiples and earnings that more readily grow in an inflationary environment should be much better hedges against rising inflation and interest rates.

One industry that is particularly exposed to rising inflation and interest rates is the retail industry. While retailers have been a prime beneficiary of the strong rebound in the economy, they will be under pressure for years until the long-term deleveraging of the consumer sector is complete. At the same time, the market is placing a relatively high multiple on projected margins and earnings which are both approaching peak levels (see Exhibit 5). Rising inflation and interest rates could pressure retailer earnings and multiples, the mirror image of the factors that have produced their strong performance over the last year.

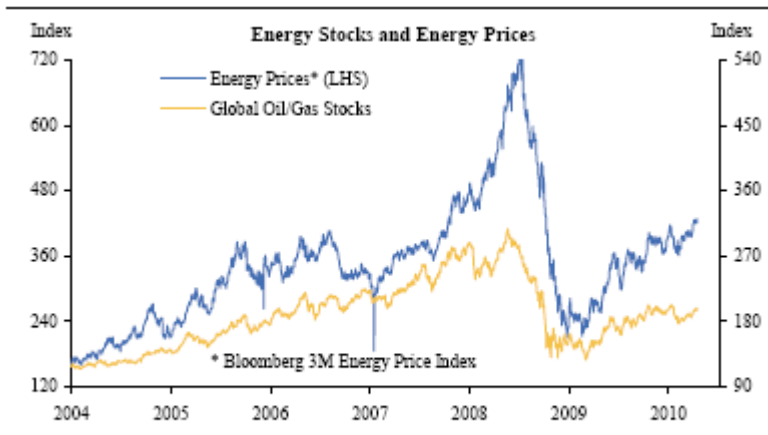
Exhibit 5 – Retailers: Multiples and Margins Could Come Under Pressure



Sources: Bloomberg L.P., equal weighted composite of 89 retailers created by Diamond Hill Capital Management, Inc.

Unlike retailers, low cost oil and gas producers sell at low price-to-earnings multiples. Further, commodities such as oil and gas are priced off the marginal costs of production, so oil and gas producers should be able to offset rising costs with higher prices (see Exhibit 6). Thus, we expect that they will perform relatively well in a rising inflation and interest rate environment.

Exhibit 6 – Oil and Gas Stocks Should Rise with Inflation



Source: Data Stream, Morgan Stanley Research

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Just as stocks are exposed to interest rate risk, corporate bonds may give investors exposure to equity risk, with a lower risk of a permanent loss of capital. While low-yield, longer maturity Treasuries are most exposed to rising inflation and interest rates, shorter maturity corporate bonds (e.g., maturities inside of seven years) may be a reasonable place to generate yield while waiting for the macroeconomic situation to play out.

The table below (Exhibit 7) shows how corporate bonds performed compared to the S&P 500 Index during the recent crisis, as well as during the trailing 5-, 10-, and 20-year periods.

Exhibit 7

	Bear Market (12/31/07 to 3/9/09)	5 Years Ending 3/31/10 Annualized	10 Years Ending 3/31/10 Annualized	20 Years Ending 3/31/10 Annualized
S&P 500 Index	(52.5) %	1.9 %	(0.7) %	8.6 %
Merrill Lynch U.S. Corporates BBB Rated Index	(10.0) %	6.2 %	7.1 %	7.9 %
Merrill Lynch U.S. High Yield Master II Index	(28.1) %	7.7 %	7.2 %	9.2 %

Source: Bloomberg L.P.

While past performance does not dictate the future, the most recent crisis was as good a stress test as we have seen since the Great Depression. Compared to a loss of 53% for the S&P 500 Index, BBB-rated corporate bonds lost 10% and high yield bonds lost 28% from the end of 2007 until March 9, 2009. Yet returns from both BBB-rated bonds and high yield bonds have been much better than stocks for the five and ten years through March 31, 2010 and have been comparable for the twenty years through March 31, 2010.

To summarize, we believe that investors should position their portfolios for the possibility of rising inflation and interest rates over a five-year time horizon and beyond. Stocks with reasonable valuations and the ability to offset rising costs with higher prices should do relatively well, while stocks with high multiples and weak pricing power may prove vulnerable. Also, shorter maturity corporate bonds may be a reasonable place to generate yield while waiting for other markets to price in rising inflation and interest rates.

Bill

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The Standard and Poor's 500 Index is a capitalization-weighted index of 500 stocks. The index is designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The Merrill Lynch U.S. High Yield Master II Index tracks the performance of below investment grade U.S. dollar-denominated corporate bonds publicly issued in the U.S. domestic market.

The Merrill Lynch U.S. Corporates BBB Rated Index is a subset of the Merrill Lynch U.S. Corporate Index including all securities rated BBB1 through BBB3, inclusive.

The Merrill Lynch U.S. Corporate Index tracks the performance of U.S dollar-denominated investment grade corporate debt publicly issued in the U.S. market.