Inflation and the Value Investor

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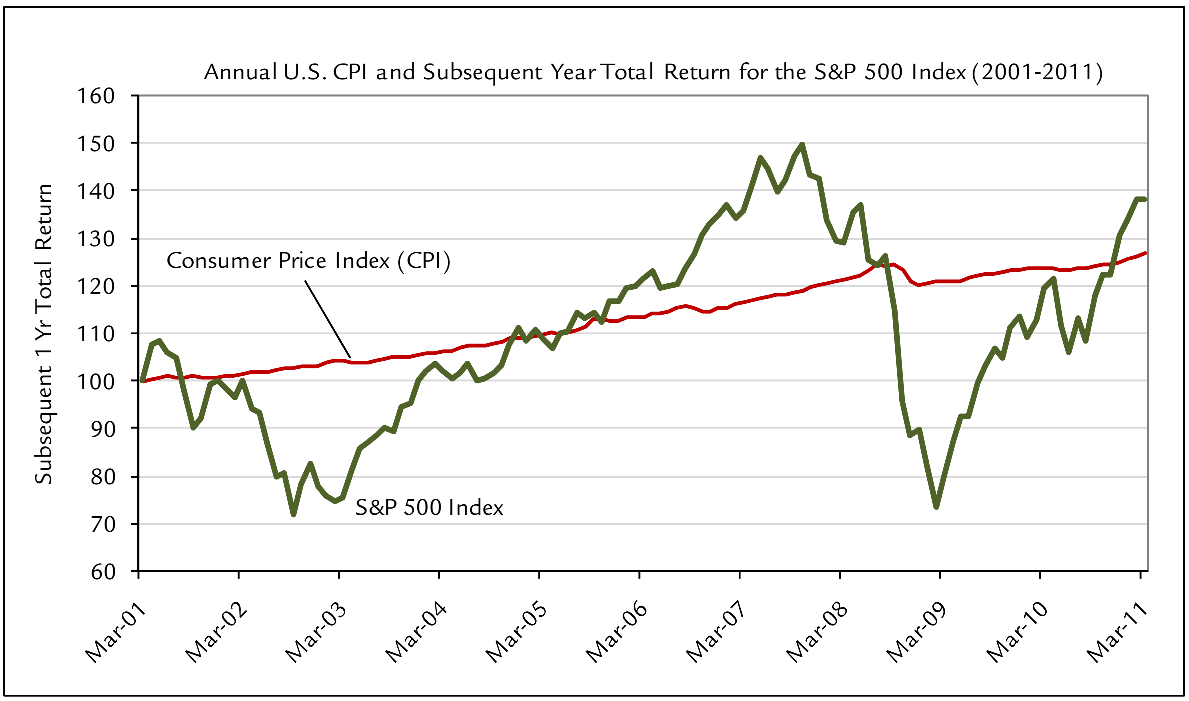
Inflation and its implications for stock market returns have garnered a lot of press recently. But history suggests that the relationship between inflation and the performance of stocks has been inconsistent and unpredictable.

The chart below compares the performance of the S&P 500 Index with the Consumer Price Index (CPI) – a widely followed gauge of inflation – during the 10 years ending March 31, 2011. As the chart shows, inflation tended to march upward at a slow, steady pace, while the S&P 500's performance included two periods of substantial decline and two periods of substantial appreciation.

S&P 500 Index More Volatile Than Consumer Price Index



Source: FactSet, as of 3/31/11. Past performance is not a guarantee of future results.

Over the period portrayed in the chart above, the CPI and the S&P 500 posted a quarterly correlation of less than 0.1, which is much closer to a correlation-free value of 0.0 than a perfectly-correlated value of 1.0.

So how reliable is inflation as a predictor of stock market returns? A comparison of annual CPI changes with the following year's S&P 500 performance highlights the challenges of using inflation as a forecasting tool:

Annual U.S. CPI and Subsequent Year Total Return
for the S&P 500 Index (1989 2010)
As ordered by U.S. CPI

YEAR	U.S. CPI	FOLLOWING YEAR S&P 500 TOTAL RETURN
2008	0.00%	26.50%
2001	1.60%	-22.10%
1998	1.60%	21.00%
1997	1.70%	28.60%
2003	2.00%	10.90%
2002	2.50%	28.70%
2006	2.50%	5.50%
1995	2.50%	23.00%
1994	2.60%	37.60%
1999	2.70%	-9.10%
2009	2.80%	15.10%
1993	2.80%	1.30%
1992	3.00%	10.10%
1991	3.00%	7.60%
2005	3.30%	15.80%
2004	3.30%	4.90%
1996	3.40%	33.40%
2000	3.40%	-11.90%
2007	4.10%	-37.00%
1989	4.60%	-3.10%
1990	6.30%	30.50%

Source: FactSet, as of 3/31/11. Past performance is not a guarantee of future results.

As the table above shows, some years of relatively low inflation were followed by strong returns for stocks, but other low-inflation years were followed by less robust returns. Similarly, some high-inflation years were followed by big gains for stocks, while other high-inflation years gave way to weak returns for equities.

Overall, while changes in the Consumer Price Index do seem to be somewhat correlated with changes in the S&P 500, inflation may not be a reliable gauge of the future performance of stocks. Accordingly, investors who avoid stocks due to inflation concerns may miss out on attractive investment opportunities.

This point dovetails with an observation in *The Intelligent Investor*, a book by Ben Graham, who is widely considered the father of value investing. "There is no close time connection between inflationary (or deflationary) conditions and the movement of common-stock earnings and prices," Graham wrote.[1]

[1] Graham, Benjamin. *The Intelligent Investor: A Book of Practical Counsel.* 4th Revised Edition. New York: HarperCollins. 2003. Page 51.

The S&P 500 Index with gross dividends is an unmanaged, market capitalization weighted index that measures the equity performance of 500 leading companies in leading industries of the U.S. economy. The index includes 500 leading companies in leading industries of the U.S. economy, capturing 75% coverage of U.S. equities. This index includes dividends and distributions, but does not reflect fees, brokerage commissions, withholding taxes, or other expenses of investing.

Correlation is computed into what is known as the correlation coefficient, which ranges between -1 and +1. Perfect positive correlation (a correlation co-efficient of +1) implies that as one security moves, either up or down, the other security will move in lockstep, in the same direction. Alternatively, perfect negative correlation means that if one security moves in either direction the security that is perfectly negatively correlated will move in the opposite direction. If the correlation is 0, the movements of the securities are said to have no correlation; they are completely random.

CPI is an inflationary indicator that measures the change in the cost of a fixed basket of products and services, including housing, electricity, food, and transportation. The CPI is published monthly. Also called the cost of living index.

You cannot invest directly into and index.

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