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Reflation and How to Exploit It

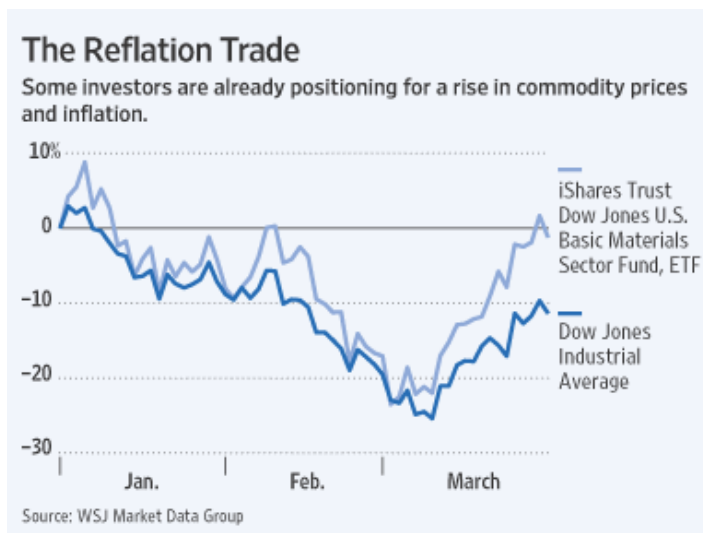
Some Bet Commodities Will Boom as Stimulus Restarts Global Economy

By TOM LAURICELLA and CAROLYN CUI

The most talked-about investing strategy these days isn't stuffing money in a mattress, it's the reflation trade -- the bet that the world economy will rebound, driving up interest rates and commodities prices.

Even though the economy continues to struggle, investors are looking ahead to time when the massive rescue efforts by central banks and governments gain traction.

They are focused on raw materials and commodity-related stocks that would benefit from the surge in infrastructure spending. They are looking to exploit potential bottlenecks in production that could lift prices and corporate earnings. Some are layering on insurance against a spike in inflation should central banks lose control of their stimulus efforts.



"Between the bailouts and the stimulus, it's pretty clear that we're going to have some inflation when we get out of this mess," says Roger Ibbotson, founder of Ibbotson Associates and chairman of hedge-fund manager Zebra Capital Management. It may not show up for another two years, he says, "but after that I think it's quite likely and I think you should be positioning a portfolio against that."

Evidence of the trade shows up in higher yields on bonds that adjust for inflation and a surge in prices for commodities including copper, up 19% in March, zinc and oil.

Shawn Rubin, an adviser at Smith Barney in New York, has moved some clients partly into natural-

resources stocks while using strategies to protect against a spike in inflation.

One way is to use options, where an investor is able to use relatively small amounts of money and take positions that would profit from a massive drop in Treasury prices or a near doubling in gold prices. While in the short run such trades may not work, "it's a long-term move," Mr. Rubin says. "You want to buy insurance when it's cheap."

For now, the U.S. remains in a deflationary mode. The economy is believed to have contracted roughly 5% in the first quarter. Consumer prices are expected to post a year-to-year drop of 1.3% through June, according to the latest Wall Street Journal survey of economists.

And despite the recent rally that lifted stocks 20% from their lows as of Thursday -- the common definition of the return to a bull market, though they promptly fell again Friday -- most investors expect a challenging environment well into next year.

But the Federal Reserve has taken dramatic steps to revive the economy and stabilize the financial system. It has lowered interest rates essentially to zero and is on track to pump more than \$2 trillion into the credit markets.

On top of that, there is the \$787 billion federal stimulus program coupled with a growing budget deficit. Around the globe central banks and governments are making similar moves.

Paul Kasriel, director of economic research at Northern Trust, says the Fed will likely err on the side of ensuring the recovery is sustained "and usually that means they will be late" in turning against inflation. The "political sentiment will be toward inflation and in preventing deflation," he adds.

Until a few weeks ago, investors weren't even thinking about preparing for a recovery, hoarding cash and U.S. Treasury bonds and defensive stocks that would perform better than most in a recession. And the longer the economy takes to rebound, the longer it will take for the so-called reflation trade to pay off. In the meantime, investors with those bets run the risk of big losses.

"Until real demand recovers, the trade has a chance of getting ahead of itself," says Mark Liinamaa, natural-resources analyst at Morgan Stanley.

Mr. Liinamaa suggests investors keep a "survivor bias." That means "looking for names that have low cost structures and balance-sheet capacity to still be standing" even if demand doesn't recover soon. He cites steel producer [Nucor](#) as one example.

Already there are signs that the market is less worried about deflation. That's clearest in the market for Treasury Inflation-Protected Securities. Back in February, five-year TIPS were priced for a 0.5% drop in consumer prices, now that's swung around to a 1.35% increase.

Inflation Indicator

The magnitude of the expected inflation rise predicted by TIPS may be small, but the direction tells the tale, says John Hollyer, a co-manager of Vanguard Inflation-Protected Securities Fund.

"The fiscal and monetary stimulus are causing investors to say there's a decent chance the Fed will be successful and there will be an increase in inflation," he says.

Other markets are yet to reflect a shift toward inflation fears. In the Treasury market, where inflation erodes the value of the interest payments over time, the 10-year bond is yielding just 2.761%.

But it isn't just the ripples from the money flooding into the financial system that has some looking at a "reflation" trade. Even if there isn't a strong recovery, the economic collapse has taken substantial amounts of raw-material production offline.

Reduced inventories could in turn result in price-rise bottlenecks even with just a moderate rebound in demand from commodity users.

"You could see a reflation in commodity prices even without broad inflation in the overall economy," says Jason

Trennert, chief investment strategist at Strategas Research Partners LLC. He is recommending energy and materials stocks, as well as an exchange-traded gold fund, to play the reflation trade over the next one to three years.

Bounce Off the Low

The possibility of rising commodity prices without inflation was highlighted last week in a report from Cambridge Energy Research Associates estimating that half the new oil and gas production that was in the works is now at risk of being deferred or canceled. While crude-oil prices are still down 64% from their high hit last summer, they are up 54% from their low hit on Feb. 12 and are up 17% this year.

It isn't just Washington's stimulus that has investors preparing for inflation. For many, the source of potential capacity constraints could well be China.

"China's stimulus package may be even more important for the inflation trade than what happens in the U.S." says Mr. Trennert. China pledged to devote nearly 75% of its \$586 billion stimulus package to infrastructure development and reconstruction of an earthquake-stricken area. The U.S. is allocating just \$48 billion to direct infrastructure spending.

China Impact

China's efforts have rippled through to the markets for at least a few metals. Prices for copper, commonly used in power generation and construction, are up 44% from the low hit in December. Zinc, needed for producing galvanized steel used by utilities and the auto industry, is up 24% from its low.

Rising prices stand to benefit the commodity-producing economies. That has encouraged John Baur, a co-manager of Eaton Vance Global Macro Fund, to avoid long-term U.S. Treasurys in favor of Brazilian debt. That country's stock market is up 12% this year.

China's refined-copper imports soared 99% in February from a year ago, perhaps indicating that "they want to have the material available" when infrastructure projects start, says Catherine Virga, a researcher at commodities research firm CPM Group.