



# Weekly Market Commentary



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## Inflation Infatuation

### Jeffrey Kleintop, CFA

Chief Market Strategist  
LPL Financial

### Highlights

Back in mid-March, we forecast a stock market rally driven in part by a change in the trend in inflation. Since then, non-energy commodity prices have pulled back about 10% and the S&P 500 has posted a gain of about 10%.

With the primary driver of overall inflation stemming from global food and energy commodity price pressures, the key to falling inflation may be a slower pace of developed foreign and emerging market growth.

When in the past slowing global growth was joined by falling commodity prices, the combination made a very good backdrop for equities, resulting in powerful stock market rallies averaging 25%. The magnitude of these previous rallies suggests additional stock market gains may be in store, as measured by the S&P 500.

#### 1 Non-Energy Commodity Prices Have Pulled Back from Peak

S&P GSCI Non-Energy Commodity Prices Spot Index



Source: Bloomberg

As we have highlighted in recent commentaries, the widely watched challenges such as a sluggish economy, falling home prices, and rising unemployment are all lagging indicators of stock market direction. One of the key factors we are watching to assess the sustainability of the stock market rally over the past couple of months is the outlook for inflation. The year-over-year pace of inflation, excluding energy and food prices, remains in line with the 10 year average and in the middle of the 2-3% range it has been in for the past three years. However, energy and food commodity prices have been soaring, bringing the overall pace of inflation to 4% and the high end of the range of the past 10 years. Increasingly, commodity prices are driving the direction of stocks. Last week, non-energy commodities, measured by the GSCI non-energy index, which includes agricultural products, precious metals, industrial metals and livestock, rose for the first time since mid-April and the S&P 500 fell. During the prior two weeks, non-energy commodity prices were falling and stocks posted gains.

Back in mid-March, we forecast a stock market rally and commented that in the past, the key to the change in direction in the stock market was not a turn around in the economy, but a change in the trend in inflation, which we believed was about to happen. Since then, non-energy commodity prices have pulled back about 10% and the S&P 500 has posted a gain of about 10%. It is worth noting that oil prices have risen 20% during this period, suggesting that it is the breadth of commodity prices changes and not just a rise in oil that is driving the inflation outlook.

With the primary driver of overall inflation stemming from global food and energy commodity price pressures, the key to falling inflation may be a slower pace of developed foreign and emerging market growth. This slowdown appears to be unfolding. Last week's European economic data (retail sales, industrial production) were both weak, and weaker than expected. Leading indicators are falling in the developing markets, as well. In China, the pass through of some of the higher food and energy prices, this winter's severe weather, the 40% plunge in the Shanghai composite stock index, and the start of the Olympic-size hangover from the slowdown in all the preparatory infrastructure spending, all topped off with tighter monetary policy, certainly raise the risk of a slowdown as the global growth engines are shifting into a lower gear (with the possibility of reverse on the horizon). In April, China's oil imports fell for the first time in 18 months. We will be watching closely as China releases a lot of economic data this week. The six month percent change in the index of leading economic indicators for China has fallen below 10% for the first time since the 2001 global recession.

Global growth is likely to continue to slow in the coming quarters (even as U.S. growth may begin to recover modestly). In the past, this slowing led

## 2 Leading Economic Indicators for China are Falling



When in the past slowing global growth was joined by falling commodity prices, the combination made a very good backdrop for equities (12/31/74, 3/31/1980, 10/31/90), resulting in powerful stock market rallies averaging 25% - even before U.S. and global economic growth began to recover.

to a downturn in inflation and a decline in commodity prices. When in the past slowing global growth was joined by falling commodity prices, the combination made a very good backdrop for equities (12/31/74, 3/31/1980, 10/31/90), resulting in powerful stock market rallies averaging 25% - even before U.S. and global economic growth began to recover. In fact, this was the case even though U.S. and overseas economic growth was still slowing for quarters to come.

Rather than act as a drag on stock market performance, slower economic growth overseas will likely help to extend the recent rise in the value of the dollar and act as a drag on commodity prices, which may allow valuation multiples for U.S. stocks to expand and drive additional stock market gains. However, this driver of performance will have to contend with challenges such as the typical election-year pattern of performance that in the past has kept the stock market in a range around where it started the year until the fourth quarter. The pullback in the market late last week followed the peak of the recent rally on May 6 – a date we highlighted last week as one of the dates in May that could result in a pause in the advance or cause a modest, temporary pullback to ensue. We also highlighted May 13 and 15 this week as days that may pose a challenge. However, we do not believe that stocks will retest the lows of mid-March. Stocks may find support from the robust earnings breadth of S&P 500 companies (with the average company posting a solid year-over-year gain in the first quarter), the potential lift to consumer spending from tax rebates already being delivered to tax payers, and the ongoing narrowing of risk premiums in the credit markets.

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