



Today's Guest
GARY DVORCHAK
The Edge |

Gary Dvorchak, managing partner of Aviance Capital Management, is filling in for Doug Kass through Thursday. Email Dvorchak at gary.dvorchak@thestreet.com. Doug will return on Friday.

That '70s Show?
2/21/2008 9:01 AM EST

QuickTake

Bullish DE MOS ADM HPQ UST CG ABX
Update TLT MO FCX

- Don't lose sleep over the recession.
- Worry about inflation, here it comes in full force.
- Stagflation is the theme for the next year or two.

The economy and the stock market are going to look like "[That '70s Show](#)" for the next year or two, barring a major about-face from the Fed.



Yes, it's possible we are in (or are about to enter) a recession. Some will argue about the depth and duration; I don't think it will be terribly deep, and much may already be priced in to the market. What I am losing sleep over right now is the prospect for an aggressive bout of inflation, driven by the Fed's (necessary) massive credit creation over the last six months. Yesterday's CPI was up at a 6.8% rate over the last three months. That puts our [Misery Index](#) at nearly 12, not inconsequential considering that the [Misery Index averaged 16](#) during the Carter years.

The evidence of accelerating inflation is indisputable. Look at gold, oil, other metals, foodstuffs. The charts are all up and to the right.

Weekly Gold



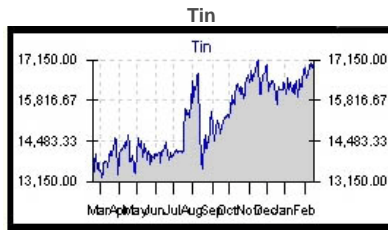
[Click here for larger image.](#)
Source: TheBullionDesk.com

One-Year Copper

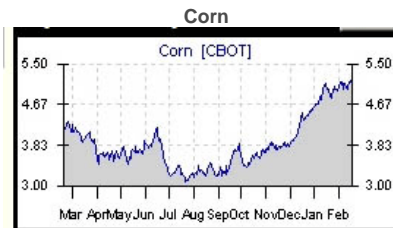


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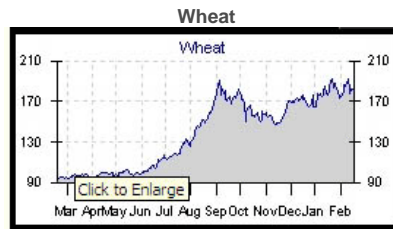
Source: [Kitco.com](http://www.kitco.com)



Source: TheFinancials.com



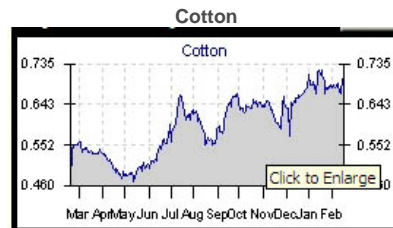
Source: TheFinancials.com



Source: TheFinancials.com



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Many pundits try to explain any particular commodity by looking at its individual market.

- Aluminum is up? Boeing orders are strong.

- Corn is up? Ethanol.
- Copper is up? Tech equipment demand.

And on and on. These pundits are completely missing the point.

The only way you can explain all these commodities rising in unison is that inflation has taken hold. There is no other reason for coffee and gold and oil and wheat and tin to all rise simultaneously. Some will point to declining house prices as a sign of "deflation." Wrong. WRONG! *WRONG!!!*

Inflation is a general debasement of the value of a dollar that shows up broadly throughout the economy. During an inflationary period, it is certain that some items will still decline in price due to fluctuations in supply and demand. Just because houses are getting less valuable does not mean that the dollar is getting more valuable; in fact, the evidence points overwhelmingly toward the opposite -- that the dollar is shrinking.

If you don't think that the dollar is becoming less valuable, take a look at it against other major currencies.



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Source: [Yahoo! Finance](#)



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Source: [Yahoo! Finance](#)

The dollar is in the midst of a sustained and severe decline vs. the world's other major currencies. This alone confirms our thesis: The value of a dollar is shrinking, and that is the definition of inflation, folks.

As I mentioned earlier, this acceleration in inflation is being driven by the Fed's massive (yet necessary) credit creation. Look at this chart of money of zero maturity, or MZM, a measure of liquid money supply compiled by the St Louis Fed.



[Click here for larger image.](#)

Source: [St. Louis Fed](#)

The amount of money created is astounding, over 16% growth in the last year, *far* in excess of GDP growth, which is the benchmark for necessary MZM growth. A lot of new dollars are chasing the same amount of goods, which is the classic recipe for inflation.

So what are the implications?

1. Long bond yields are likely to rally from here, driving down long bond prices. Doug Kass has been on top of this with his short **iShares Lehman 20+ Year Treasury Bond** (TLT) trade.

2. Rising long yields and low short rates will steepen the yield curve, enabling the slow recovery of the financials.

3. Rising long yields will abort any chance for much lower mortgage rates, so distressed borrowers will not get bailed out by refis and housing demand will not get jumpstarted by better financing terms. Don't look for a recovery yet in the homebuilders.

4. Position your portfolio for the best inflation plays. Ag is great: Look at **Deere** (DE), **Mosaic** (MOS) or **Archer Daniels Midland** (ADM). U.S. companies with substantial non-U.S. dollar sales will do well: Look at **Hewlett-Packard** (HPQ), which derives 69% of its revenue from outside the U.S. Any company with pricing power, such as consumer staples, will do well: Look at tobacco plays **Altria** (MO), **UST Incorporated** (UST) or **Loews Carolina Group** (CG). And, of course, pure commodity plays, such as **Barrick Gold** (ABX) or **Freeport-McMoRan Copper & Gold** (FCX) should be profitable.

5. Brace yourself for the cessation of Fed cuts and quick increases as soon as it believes that the financial sector stresses are abating. I truly doubt that the Fed believes its own B.S. of inflation being "anchored," and it will turn its attention to the issue as soon as conditions allow.

I'll have a few more comments on inflation later today, but that is good for now.

Position: *Long DE, MOS, ADM, HPQ, UST, CG and ABX*