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FED SHADOW

Show Me the Money

Monday, November 19, 2001

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The V-shaped recovery scenario now dominating market sentiment has powered equities to impressive gains and caught off guard in particularly vicious fashion a Treasury market priced for bond-buyers' nirvana (i.e., deflationary recession). The sight of the gold price retreating to its pre-September 11 levels around $272 per ounce, however, stands as clear warning of the risk that a deflated dollar still poses to the current feel-good market climate. The gold capitulation coming in synch with the positive war news from Afghanistan appears to furnish final confirmation that the post-9/11 price pop represented a pure safe-haven premium without monetary content. We're on alert for evidence pointing in a more positive direction, but at this point the gold signal appears consistent with a number of other indications suggesting that nascent signs of a bottom in real economic conditions should not yet be confused with the foundations for robust recovery.

First, despite a number of reports to the contrary, we see little indication yet that credit quality concerns are easing sufficiently to render appealing the outsize risk premium currently available in corporate debt instruments, including those carrying investment-grade ratings. Much has been made in certain quarters about the recent tightening of spreads. For the most part, though, that tightening was explained more by last week's surge in Treasury yields than any accompanying rally in corporate debt. The spread on 10-year Triple-B rated industrials, for example, has closed by some 15 basis points over the last two weeks. But a good part of that tightening came last week when 10-year Treasuries blew out by some 53 basis points, while losses on Triple-Bs tacked on "only" another 45 bps. Obviously, that sort of squeezing is not going to translate to an abundance of credit being made available to lower-rated borrowers.

It is also difficult to discern much evidence of deflation relief in the recent bounce of several commodity indexes off their multi-year lows last month. The Dow Jones Spot Index, for example, is up about 2.5% from its levels last month, but still down more than 12% on the year. Similarly, the CRB Futures Index, although it has recovered by about 2.7%, remains more than 16% below its levels at the start of the year. True, these gauges have been distorted to an extent by the recent oil price plunge. But consider that the LME Metals Index, although up nearly 12% from its lows earlier this month, is off more than 15% year-to-date. By and large, the commodity price bounce appears mainly to signal a recovery from the post-9/11 shock rather than an easing of more deep-seated monetary strains.

Perhaps we could credit these indexes as at least affirming a marginal decline in dollar scarcity were they supported by any other sensitive market indicators of the currency's strength. But the dollar has appreciated nearly as much the last several weeks in terms of foreign exchange as it has against gold, up nearly 5% against the G-6 currencies on a trade-weighted basis. Indeed, based on the G-6 Dollar Index, the greenback is now stronger relative to the other major currencies than it was prior to the terrorist attacks.

Nor did the remarkable sell-off in Treasuries last week appear to have been tied in any real sense to relief from deflation expectations. Were that the case, we would likely have seen the short end of the curve outperforming long maturities. Instead, the 30/2-year curve actually

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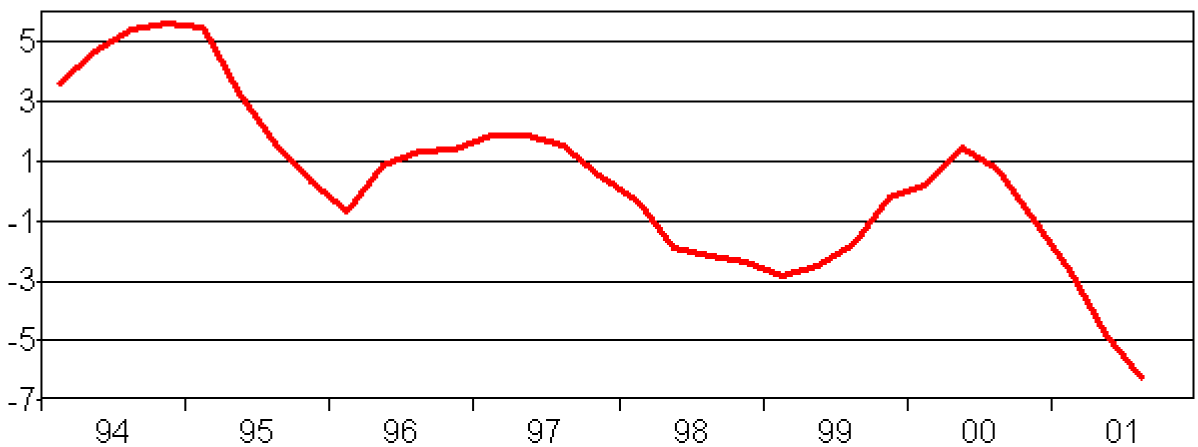
flattened by some 17 basis points last week, as the short end was disproportionately hammered by the reversal of **Fed** rate cut expectations. Indeed, the surge in yields – with the long bond at nearly 5.3% -- should probably be seen as a short-lived opportunity to capture an appealing premium on a real-purchasing-power basis. We rate it as unlikely that the Fed is now prepared to stand pat based on a few tentative indications that the economy's pace of contraction might be leveling off. Revival of Fed rate-cut expectations should bring long yields back into a range around 5%.

We can have no particular confidence, of course, that with a current overnight rate of 2%, a lower funds rate target will necessarily translate into meaningful deflation relief. After 450 bps in cuts thus far, indications of such relief remain scant, and hope for a "magic bullet" wanes as the **FOMC** steadily exhausts its margin for additional rate-cutting action. Without a regime shift into some sort of price-rule orientation that would have as its overriding objective relief from an excess dollar scarcity, the Fed risks moving into increasingly treacherous territory.

The accompanying chart provides some illustration of that risk. Velocity, the ratio of nominal output to money supply, measures the turnover rate of money in the economy. Velocity falls to the extent that the demand for money rises relative to the goods for which it exchanges. Eventually, an extended period of declining velocity results in contraction of nominal GDP. At this point there is little indication that velocity, which fell for the fifth consecutive quarter in the June-September period, dropping more than 6% on a four-quarter basis, has arrested its decline. With nominal output essentially serving as a proxy for corporate revenues and earnings, the risk to current market prices of a Fed that fails to get ahead of the deflation curve is becoming all too apparent.

M2 Velocity: Nominal GDP/M2 money supply
Four-quarter percent change



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