TrendMacrolytics

Donald Luskin, Chief Investment Officer
David Gitlitz, Chief Economist
Thomas Demas, Managing Director

MACROCOSM

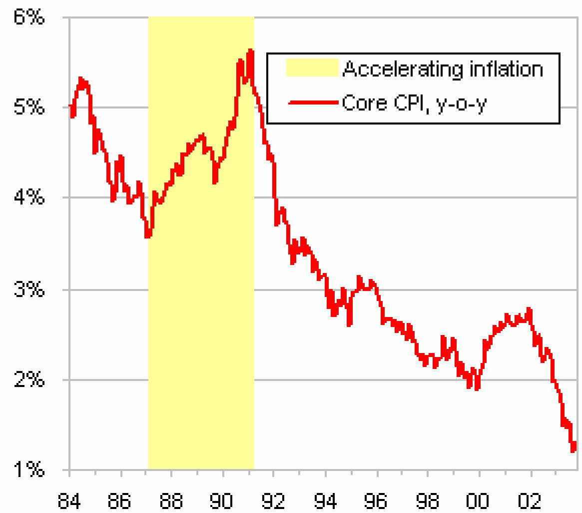
The Inflation Chartbook

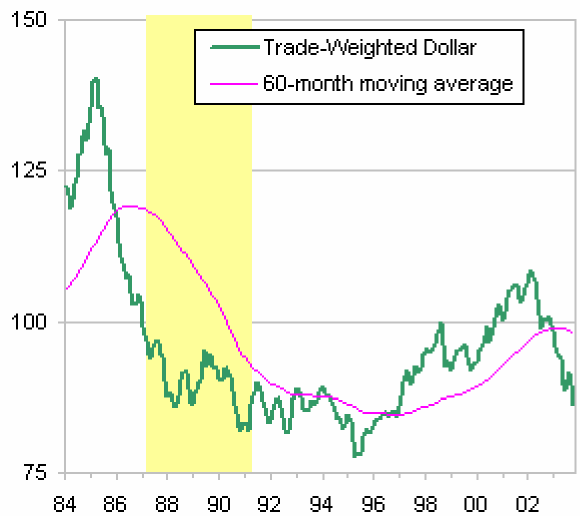
Tuesday, December 2, 2003

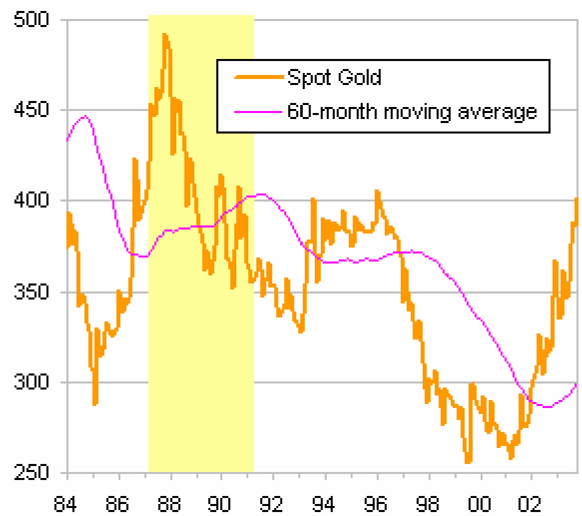
Donald Luskin

Despite what the Fed says, forward-looking market-based metrics point to inflation.

There has not been a major acceleration in statistically-measured inflation since the period from March 1987 to March 1991, which began just before **Alan Greenspan** took office as chairman of the **Federal Reserve**. That was not a hyperinflationary spike of the kind seen a decade before. But it coincided with a very difficult time for markets, characterized by rising Treasury yields, global currency tensions, and equity returns that were both highly volatile and mediocre. Today, the two most direct, forward-looking, market-based measures of inflation are moving toward positions much like those just before the 1987 inflationary acceleration.







THE DOLLAR: The 1987-1991 inflationary acceleration was preceded by a 30% drop in the foreign exchange value of the dollar, and a downturn in the dollar's long-term trend. Today the dollar has dropped 20%, and the trend has turned down.

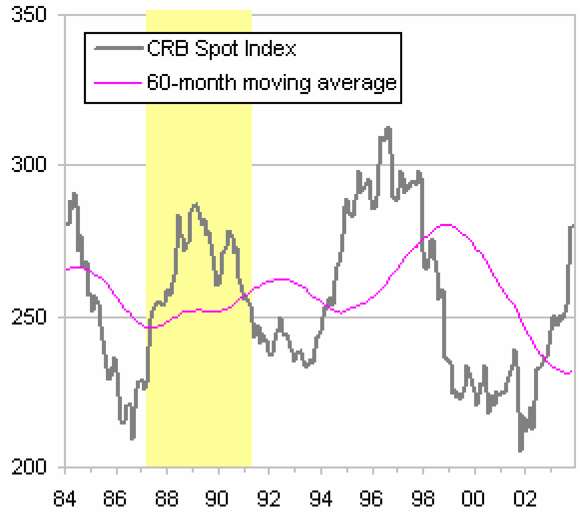
GOLD: The 1987-1991 acceleration was preceded by a 71% run-up in the spot price of gold, and an upturn in the long-term trend following a sustained deflationary drop. Today spot gold has rallied 57%, and the trend has turned up from a similar deflationary drop.

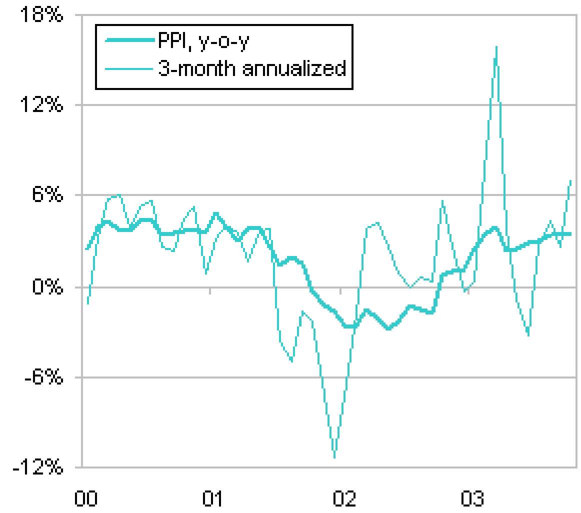
http://www.trendmacro.com
don@trendmacro.com
dgitlitz@trendmacro.com
tdemas@trendmacro.com

Offices:
Menlo Park CA
Parsippany NJ
Stamford CT

Phone:
650 429 2112
973 335 5079
203 322 1924

Gold and the forex value of the dollar are the two most direct inflation metrics. But there are other somewhat more ambiguous ones, and they are pointing toward an inflationary acceleration as well.





COMMODITIES: The 1987-1991 inflationary acceleration was preceded by a 21% run-up in the CRB Spot Index (which excludes oil), and an upturn in the long-term trend. Today the index has already rallied 36%, and the trend is just beginning to turn up. Note that the CRB's run-up in 1994, which did *not* precede an inflationary acceleration, was not confirmed by gold.

PPI: Of all the statistical measures of inflation, the Producer Price Index is the most sensitive and volatile (it was the only one to register concrete *statistical* evidence of monetary deflation). PPI inflation has been quietly rising since May 2002, and has now increased from negative 2.9% to positive 3.4% year-on-year basis -- an up-swing of 6.3%. We note that even lagging CPI inflation has turned higher on a 3-month annualized basis.

Focused only on long-term statistical measures and on fallacious econometric models, the Fed continues to ignore these market-based inflation signals. But we are beginning to see some signs that, perhaps, the market may be beginning to come around to our point of view. We note that the "Heard on the Street" column in yesterday's ***Wall Street Journal*** featured inflation warnings from two celebrity investment strategists. We don't necessarily agree with all their reasoning or all their conclusions, yet they are groping in the right direction.

But the conventional wisdom on the inflationary threat dies hard. The *Journal* reporter seemingly spoke for the Fed when he waved away the strategists' concerns, saying they are "based more on emotion and expectations than on anything else. There are lots of good reasons why inflation should remain tame, mainly the lack of a strong jobs market."

As investors find their own paths to the inflationary truth, we will surely see an important realignment of expectations and valuations. We continue to believe that the Fed will get on the path, too -- sooner rather than later -- and so rate hikes are going to be faster and bigger than the market now expects. TM