TrendMacrolytics

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So Much To Lose

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The economy's robust health highlights the potential being put at risk by the Fed.

Today's final revision to third quarter GDP, confirming that the economy advanced at a blistering 8.2% annual rate, the best in 20 years, is the latest of the economic indicators portraying this recovery -- so seemingly lackluster just a few months ago -- maturing into a full-on boom. As our economic view this year has been consistently bullish against a stubbornly dour consensus, we allow ourselves some satisfaction in this run of unambiguously good news. It would be the wrong time, though, to issue any guarantees regarding the longer-run health of this expansion. If anything, the economy's current vigor underscores the potential economic gains now being put in jeopardy by the risk of serious policy error.

We have spent significant efforts documenting **the Fed's** brazen dalliance with a potentially damaging inflation breakout. Relying on the government's badly lagging price indexes, reinforced by its inherently flawed "output-gap" model, the Fed remains convinced that it can maintain its open-throttle liquidity position for a "considerable period," *i.e.,* indefinitely. Our analysis based on sensitive market price indicators, however, suggests that the Fed increasingly is falling behind the curve.

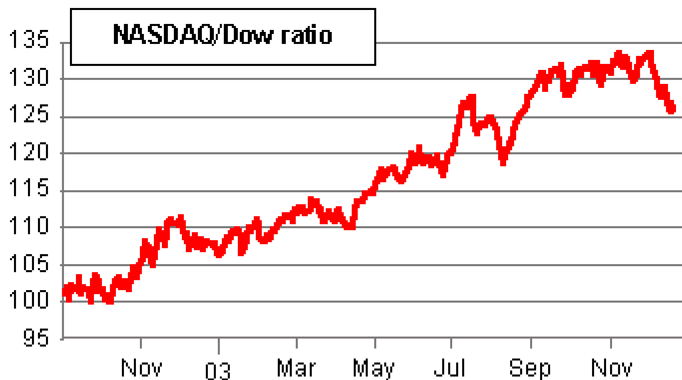
The economic risks are many. In the first instance, a sharp, unexpected rise in inflation would undoubtedly crater the bonds that have been held in check by the Fed's on-hold assurances. Obviously, such a bond yield blow-out would in itself have highly negative market and economic impacts. In addition, rising inflation directly hikes the real, effective capital gains tax rate. Since capital gains amounts to a tax on risk-taking, a higher real capgains rate would in all probability result in a substantial diminution of the market's reawakened risk preference, producing slower growth. Finally, if the Fed does not act soon enough to quell incipient price pressures, confirmation of the inflation error inevitably will force it to undertake the sort of sustained and aggressive tightening action that would put the expansion in considerable danger.

That would be all too typical of the Fed's record over the course of its history, especially since the collapse of the last vestiges of a gold standard in the early 1970s. The central bank's backward-looking perspective more often than not leaves it working to clean up after its own mess. In this case, when a massively too-tight deflationary stance in 1999 and 2000 began sharply braking the economy, the Fed initiated an easing campaign three years ago that has brought the overnight target rate down from 6.5% to 1%. Until little more than a year ago, Fed officials assiduously denied that they were in fact battling the consequences of a monetary deflation.

By the time they acknowledged potential deflation risks, however, reflation of the most forward-looking market indicators, including sensitive commodity prices and foreign exchange, suggested downward price pressures had all but been rooted out. As the Fed has continued navigating by its rear-view mirror to extinguish non-existent "disinflationary" forces, the real-time

gauges of dollar purchasing power have inexorably moved from indicating a healthy reflation of the unit of account to warning of a harmful inflation. By the time the inflationary impulses that are now bubbling beneath the surface become too obvious for **Greenspan & Company** to ignore, the Fed may have little choice but to move into the sort of long-run rate-hiking mode that would ratchet up rates to an economy-crushing level.

To this point, though, nearly all the market-based pulse-readings that we monitor to gauge the economy's growth prospects remain decidedly upbeat. In our model, risk-taking is the irreplaceable ingredient of sustainable expansion, and there are few signs in the market's risk tolerance suggesting anything but blue skies ahead. High-risk credit spreads, at less than 500 basis points, continue to narrow to levels last seen more than four years ago, and have been more than halved from their peaks of October 2002. The market for initial public offerings, after suffering its worst quarter in more than 30 years last spring, is in the midst of revitalization. In the current quarter, 53 new offerings have come to market raising $8.3 billion, more than half the $14.9 billion total for the entire year. And with the IPO window opening again, activity at the other end of the risk-capital pipeline is also picking up. At $657 million, venture capital disbursements last week had their best week in nearly two years, according to **VentureReporter.net**. In the past four weeks, VC funding averaged nearly $445, up from the somnolent four-week average of $181.5 million last June.



There is, however, one indicator of the market's risk preference that recently has begun transmitting a noticeably less optimistic signal. Over the years, we have found the ratio of the NASDAQ Composite to the Dow Jones Industrial Average to be a useful, rough-and-ready gauge of the market's risk tolerance, pitting the relatively high-risk NASDAQ against the less-risky Dow. In nearly 14 months following the market low of October 2002, the NASDAQ/ Dow ratio rose by nearly a third, as the market's extreme risk abhorrence gave way to restoration of a healthy tolerance for risk in the face of growing optimism about the economic outlook. Since early this month, underpeformance of the NASDAQ relative to the Dow has seen the ratio slip by nearly 6%. We don't suggest that this reversal is yet cause for alarm. But the prevalence in the NASDAQ of immature, entrepreneurial enterprises whose investment appeal is inextricably tied to prospects of real, after-tax capital gains makes it particularly sensitive to the risk of an unwelcome inflation surprise. Similarly sensitive to inflation, though in the opposite direction, are Dow member stocks in the basic materials sector. This recent downturn in the ratio could represent the leading edge of the market discounting for a spell of inflation the likes of which have not been seen since the late 1980s. TM