TrendMacrolytics

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

MACROCOSM

"It" *Can* Happen Here

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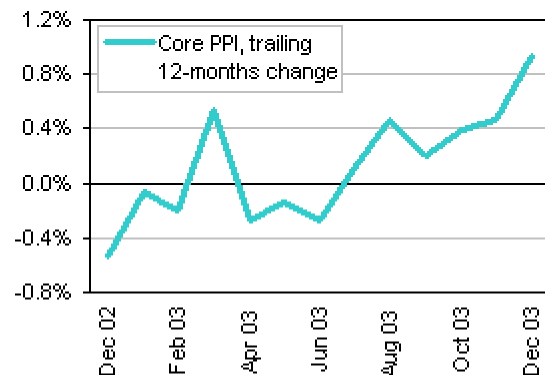
Donald Luskin

The "it" is inflation, and "it" will happen. 1987 *deja vu* all over again?

On November 21, 2002, when **Fed governor Ben Bernanke** gave a speech entitled "Deflation: Making Sure 'It' Doesn't Happen Here," he signaled that the Fed's fundamental policy orientation had changed -- from obsessing on one wrong "it" to obsessing on another. For the five years before that speech, the Fed had gradually induced the deflation that it finally had to acknowledge by staying too tight for too long, all the while imagining the "it" of inflation under every bed while ignoring manifest evidence of deflation. Now the Fed's new "it" is deflation -- which the Fed imagines that it sees in irrelevancies such as "slack resource utilization" -- while it ignores the manifest evidence of incipient inflation.

We continue to be astonished both that the Fed seems incapable of learning from history, and that so many market participants are willing to follow along in utter denial. Of course if the definition of "inflation" is the growth rate of the Consumer Price Index, then there's nothing to deny. On the other hand, the core Producer Price Index has been on the rise for the last thirteen months, and its miniscule month-over-month drop yesterday does nothing to change that. Indeed, its trailing 12-month growth rate doubled in December over the previous month, moving from 0.47% to 0.94%. Obviously, at less than 1%, the rate itself is not alarming. The important point is the abrupt shift in direction that the PPI has registered over the past year.



Be that as it may, both the PPI and the CPI are only report cards, telling us what happened in the *past*. Actually they're more like grade-point averages, in which events in the *distant* past remain embedded in current statistics. What's worse, these indices measure the wrong thing. Just as academic achievement reflected in grades is not necessarily the same thing as intelligence, changes in aggregate prices are not necessarily the same thing as *monetary* inflation (for example, a crop failure that reduces the supply of apples would cause their price to rise, but that's not inflation).

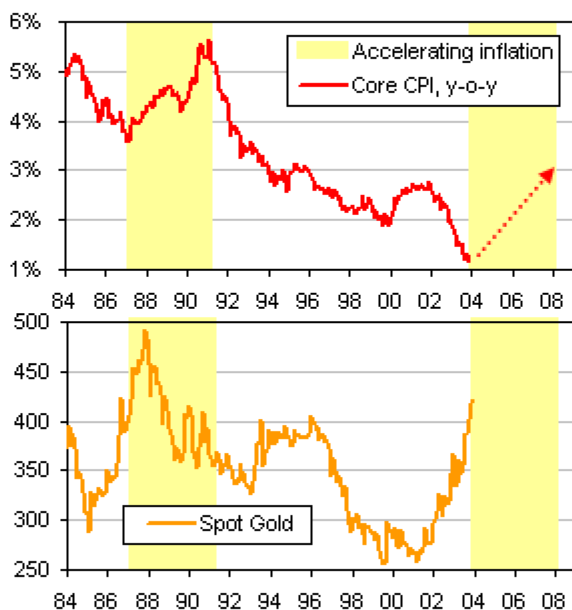
To assess the *future* prospects of inflation -- and inflation *correctly defined* as the erosion of the dollar as a "unit of account" or yardstick of value -- we look to the markets for money-like instruments priced in dollars. Gold, basic commodities and foreign currencies are highly liquid money substitutes, so *when their spot prices rise in dollar terms*, that means that the dollar as a "unit of account" or yardstick of value is eroding to the same degree. That's what's happening right now.

To be clear, we are not saying that higher gold, commodities and forex prices *cause* inflation (by virtue of higher costs of industrial inputs and imported goods), although to some extent they do contribute to a rising overall price level. What's important about them is that they signal a Fed-

induced excess of dollar liquidity which, by virtue of there being too many dollars in relation to the universe of goods, services and investment opportunities, erodes the value of the dollar relative to all things, all else equal. That erosion literally *is* inflation.

Eventually inflation, understood this way, shows up in backward-looking price indices like the CPI and the PPI. Most recently, *declines* in the late 1990s in gold, commodities and forex in dollar terms strongly forecasted the monetary *de*flation that now so deeply concerns the Fed -- but which at the time, based on conventional analysis, they argued was impossible.

More directly relevant to today's situation, *rises* in the mid-1980s in gold, commodities and forex in dollar terms strongly forecasted the monetary *in*flation that began to show up as accelerating CPI growth beginning in 1987, which wasn't stamped out until the Fed had raised the fed funds rate to almost 10% and squelched a long-standing economic expansion. In the meantime, it was a period of turbulence and sub-par performance in financial markets.

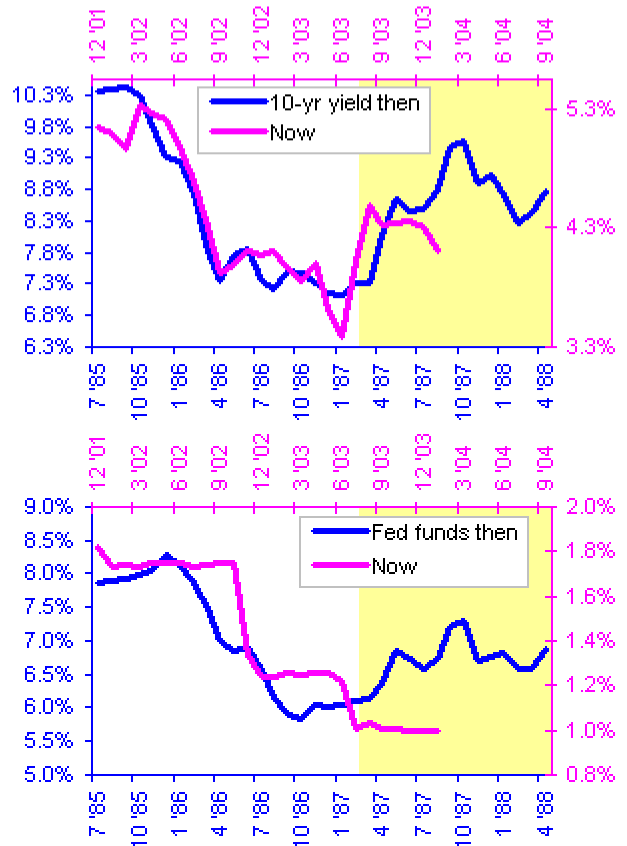


We don't mean to be misunderstood as telling an "ominous parallels" story, but the fact is that circumstances today are, indeed, eerily like those that prevailed in early 1987 (see "The Inflation Chartbook" December 2, 2003). As of yesterday's close, gold has run up 63% from the lows 35 months ago. By comparison, in March 1987, gold had risen 71% from its lows 34 months previous -- and March 1987 was the month core CPI reversed a multi-year decline and began a 49 months of acceleration. Commodities, forex and other markets show similar parallels in various degrees. Based on this there's no reason *not* to expect that CPI inflation will rise to at least between 3% and 4%. With the usual lags, we'd expect to have seen strong evidence of the reversal in statistical inflation by late this year or early next.

We reject the "this time it's different" arguments that the price level will be held down by the recent surge in industrial productivity, by cheap goods from **China**, by the joblessness of the current recovery or any other indicator of "slack resource utilization"; or that rapid growth driven by supply-side tax cuts will sop up the current excess of dollar liquidity. Some of those things may affect the prices of various goods and services, just as **Moore's Law** affects the price of semiconductors and a thousand other factors affect a thousand other prices. But all these considerations are *givens* -- they form the backdrop against which the Fed must still set appropriate policy. The fact remains that for *whatever* givens are operating in the background now, gold, commodities, forex and other market indicators are telling us that the Fed is making an inflationary error in relation to those factors.

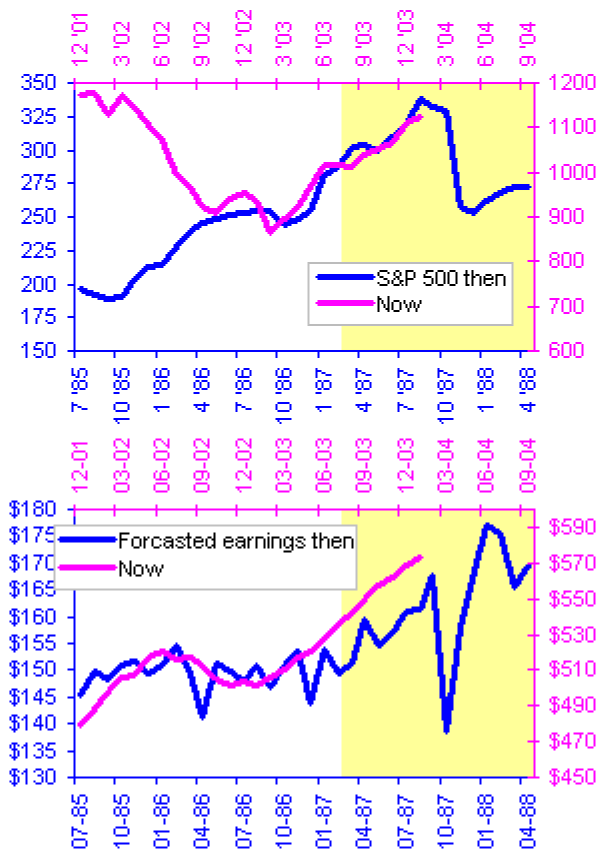
Now suppose we are right -- that CPI inflation is about to start a rise to at least between 3% and 4%. When that begins to unfold, we can be sure that 10-year Treasuries won't stay priced to yield 3.98%, where they are now, no matter what the Fed may say about some promised "considerable period." In 1987, bond yields soared 2-1/2% in just 5 months. It happened as the fed funds rate finally began to rise after dropping for the prior three years, and yields rose about twice as much as the funds rate did. It all started in April, only the second month of core CPI acceleration off what proved to be its February bottom.

The charts at right compare that turning point in 1987 to where we are today. This time bond yields are already considerably above their lows, despite no fed funds hikes or increases in CPI inflation yet. From here, yields are poised to move to at least 5% -- either because evidence of inflation too obvious to ignore finally emerges, or because the Fed begins to belatedly raise the funds rate. As we have already pointed out, the longer this takes to happen, the worse it will be (see "Bond Bubble Sure To Burst, But When?" January 13, 2004).



What about stocks? Yes, we are worried by the long-term anti-growth implications of incipient inflation (see "So Much To Lose" December 23, 2003). But we have not reduced the exposure in our **Model Position long the S&P 500** because, at the same time, we are encouraged by the powerful pro-growth implications of the recurring benefits of last year's tax cuts (see "The Tax Cut Gift that Keeps on Giving" January 5, 2004). Also, we recognize that *in the short term*, the leading edge of new wave of inflation can exert very positive technical and market-psychological effects on stock prices. Here, too, 1987 is a useful example.

Of course 1987 is remembered for the crash of October 19. But what is often forgotten is that at the high of the year on August 25, the S&P 500 had risen 40% in the eight months year-to-date. As is the case today, in 1987 there was a significant acceleration in forecasted earnings. But at the same time, there is a great deal of anecdotal evidence to suggest that the excess of dollar liquidity that produced the inflationary acceleration that began in 1987 had a role to play in what was, by any measure, an extraordinary run-up in prices.

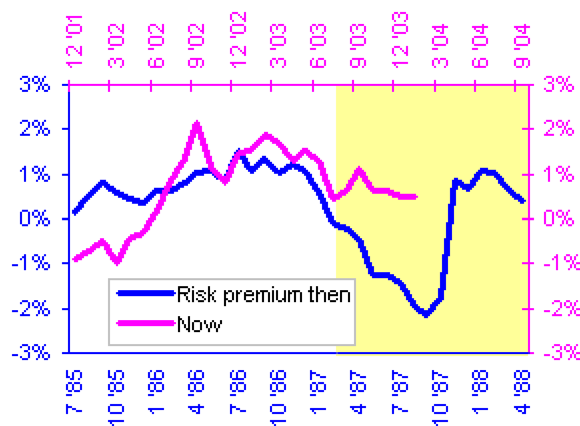


First, a steep decline in the forex value of the **US** dollar in the years before 1987 made dollar-denominated assets seem very attractively valued to foreign investors. This was the era of "trophy acquisitions" of real estate by **Japanese** interests, and sudden fluctuation in various US sectors and stocks were often anecdotally explained in the media as the result of Japanese or German buying raids. This is not so different from the anecdotes that circulate nowadays that explain various market phenomena as the result of the need for Japan and China to reinvest their dollars acquired through trade imbalances and currency interventions.

Second, in 1987, the combination of easy money in relation to expected asset inflation and earnings growth rates had led to a wave of leveraged equity acquisitions at increasingly lofty valuations. This was the era when people were even willing to borrow money in order to bid for the privilege of taking **United Airlines** private. This is not so different from today's "carry trade," in which bond market participants are incentivized by promises of low rates for a "considerable period" to take levered positions in long-term Treasuries, or simply to "reach for yield" by extending maturities. What amounts to a stock market version of the "carry trade" operates anytime an investor decides that he'd be better off taking the risk of owning equities than earning virtually nothing in cash deposits.

These two phenomena are both made possible by versions of "money illusion" -- the confusion of *nominal* values with *real* values. Or to put it more simply: the denial of incipient inflation. Financial assets priced in a weak dollar are not truly cheap, because they will generate cash flows in that same weak dollar. And "carry trades" inevitably turn out to have been based on what amount to "teaser rates." Too-low short-term rates eventually produce inflation that makes rates in the future higher than they would otherwise have been, resulting in capital losses in the levered asset. In 1987 the crash materialized when investors became focused on money reality, not money illusion. It was catalyzed at that particular moment by fears that the US dollar would be devalued even further than it already had been at that point.

When money illusion and inflation denial inevitably come to an end in today's epoch, there will be dislocations. Again, the longer we wait, the worse it will be. But we are by no means forecasting a stock market crash. So far today is different from 1987 in one very important respect. Then, illusion and denial had compounded into a risk premium that was as absurdly low as it was at the peak of the so-called bubble in early 2000 (as measured by our S&P 500 "Yield Gap" valuation model, shown in the chart at right). Today's market, in sharp contrast, offers a higher-than-normal risk premium -- perhaps significantly higher when nominal expected earnings are augmented to take into account the tax cuts on dividend and capital gains income.



Right now all the risk is on the bond side. We see both value and growth arguments for equities here (and inflation arguments, too, for the basic materials, energy and industrial sectors). But bonds at these levels are a bad accident waiting to happen at any moment. A 10-year yield of 3.98% is priced for perfection as far as inflation is concerned, and we firmly believe that the future will be far less than perfect. So as the inflation picture becomes clearer to more market participants, we expect the sequence of events to mirror 1987 in one important way -- bonds will fall first, and they will fall hard. TM