TrendMacrolytics

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MACROCOSM

Buyable Dip? Yes, But…

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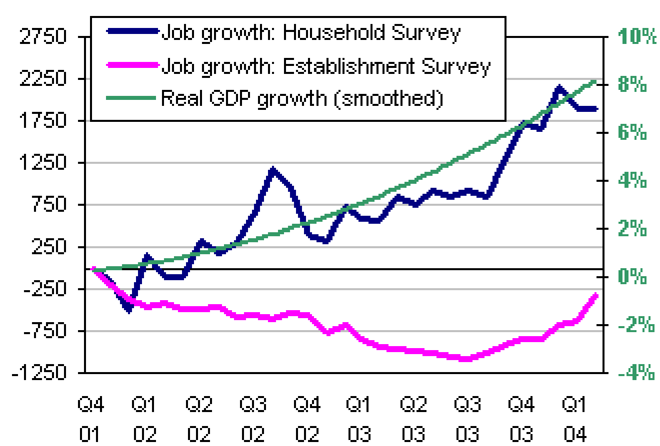
Higher interest rates are not to be feared -- provided the Fed really delivers them, and Bush dodges the political fallout.

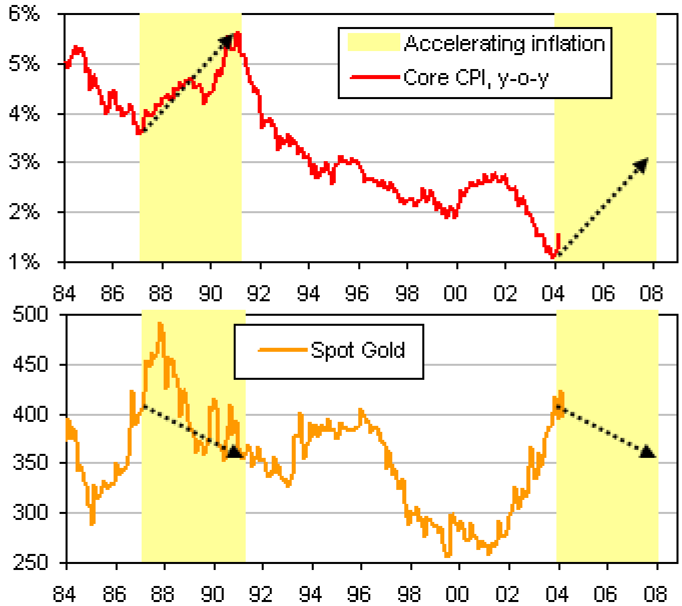
Readers of our reports shouldn't be at all surprised by the steep rise in long-term Treasury yields that has followed in the wake of this month's release of March payroll and CPI data. The drop in stock prices should be no surprise either, in light of the media hand-wringing over the inevitability of **the Fed** finally clamping down on the easy-money stimulus spigot. We've known for a long time that this day of reckoning would come for stocks, and said often that it would end up being a "buyable dip." Now that the day may well be upon us, do we still think so? Yes. Or at least, "yes but."

In at least one important sense all the data is very good news for the economy and for stocks -- even the uptick in inflation -- for a reason that has nothing to do with the data *per se*, but rather with the nature of the processes that generate the data. Economic statistical reports are *instruments* -- their readings guide policy-makers, market participants and voters. Until this month, there has been a growing sense that these important instruments are broken. A broken instrument is just as dangerous on **Alan Greenspan's** desk as it is in the cockpit of a 747.

For the last year Greenspan has been like a man trying to heat his home by setting a bonfire in his living room -- completely relying on a broken thermometer to tell him when it's warm enough, and a broken smoke alarm to warn him if the fire burns too long. Payroll jobs growth is Greenspan's thermometer -- it hasn't accurately reflected how hot the economy really is. CPI inflation is Greenspan's smoke alarm, and it hasn't warned Greenspan of the growing stench of inflation. Finally this month it appears that these instruments may be working again -- and Greenspan now has two reasons to put out the fire before he burns down the joint.



The payroll jobs numbers have, until March, been completely disconnected from virtually every other indicator of employment growth and overall economic growth. The chart at right looks at cumulative net growth of jobs according to the **Department of Labor's** "establishment survey" since the official end of the recession in November 2001. That is compared to job growth according to the DOL's "household survey," and also to cumulative real GDP growth. The household survey shows 1.89 million net jobs *gained*, which closely tracks real GDP growth of more than 8%. The establishment survey shows 323 thousand net jobs *lost*. While the payroll numbers have turned up over the last six months, growth has been sluggish and perennially below expectations. It was not until March's report that we saw the first really big above-expectations number, one that finally suggests the kind of catch-up it will take to bring the two measures of job growth into some kind of alignment. If nothing else, March proves that this particular instrument is at least still physically capable of registering a large positive number.



The quiescent Consumer Price Index has been disconnected from other indicators that all give strong evidence of accelerating inflation: run-ups in the prices of gold, metals and other commodities, the fall of the forex value of the dollar, and widening spreads on inflation-indexed securities. As the chart at left shows, very similar inflationary warnings from these other indicators began in 1985, but they didn't begin to be reflected in CPI acceleration until March 1987. During the ensuing inflationary outbreak, Alan Greenspan -- then very new to office -- had to raise the fed funds rate from 6% to 9-3/4% over two years (during which the gold price reversed well before CPI inflation peaked and turned back down). This does not prove that the CPI is "broken" -- rather, only that it is inherently a very lagging statistic. Either way, it's dangerous and foolish to use it as a real-time indicator of inflationary threats. But Greenspan uses it (and other similar indices) nevertheless -- so it's great news that, in March, it seems that the CPI's lag-period has come to an end, and it is finally registering the reality of inflationary acceleration.

So the thermometer and the smoke alarm are working again. Greenspan and other Fed policy-makers have said all along that, broadly speaking, these were the instruments they were relying upon. Now -- will they heed them and raise rates? The drop in bond prices seems to indicate that they will. And the conventional wisdom is that this will be bad for stocks. We disagree. We urgently hope the Fed *will* heed its instruments (now that they are working) -- indeed, the risk for stocks is that they *won't*.

Rate hikes won't strangle the recovery, as the conventional wisdom fears. We have grown well beyond the point at which the economy can safely be taken off emergency life support. And as **David Gitlitz** pointed out in a report on Wednesday, rate hikes from these low levels would hardly represent a real policy tightening anyway, but rather an entirely appropriate and orderly retreat from a policy of hyper-ease (see "On March CPI" April 14, 2004).

The policy risk to the economy now is the acceleration of the rate of inflation, and at this point some of that is already a virtual certainty. A rough-and-ready reading of the CPI chart above would suggest that reaching a 3% inflation rate over the next two years would be a good baseline expectation. Just as an orderly rate-hiking process here should present no special challenges to the economy, CPI inflation at 3% isn't the end of the world. Just a few short years ago, 3% was considered to be functionally identical to zero. In the end, we suspect that's how stocks will interpret it. But in the short term, now that inflation-denial has been made impossible by the March CPI -- and with no guarantee that inflation won't accelerate *beyond* 3% -- stocks will be very sensitive to indications that the Fed isn't heeding its instruments. Yesterday's speech by **Fed Governor Ben Bernanke** was mixed at best on this score. We'll learn a lot more from Greenspan's testimony next week to the **Joint Economics Committee**.

All that said, there's one element of rising interest rates that is truly troublesome -- it's connection to the November presidential elections. We've noted here many times recently that we believe that the stock market -- especially growth stocks -- would strongly prefer **George W. Bush** to be re-elected so that his pro-growth tax policies can be extended, and we've highlighted the tight relationship between rises and falls in Bush's re-election probabilities with rises and falls in the NASDAQ. The NASDAQ 100 has fallen more than 4% over the last week since we closed out our **long Model Position**, noting at the time the drop in Bush's chances in light of heightened uncertainty about **Iraq** (see "Tech: Back in Harm's Way?" April 8, 2004).

There is no doubt that the **Kerry** campaign would use rising interest rates to cast doubt on the booming economy, appealing to close-to-the-heart fears of a collapse in housing prices and more remote fears of spiraling federal deficits. These fears may be irrational in our view, but nevertheless we've already seen how skillfully the **Democrats** have been able to incite them during their primary season. So while we are not troubled by rising rates *per se*, with electoral risk increasing we remain concerned that the highest-growth sectors of the equity market won't adequately compensate investors for risk-bearing over the next several months. TM