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A Buyable Consolidation?

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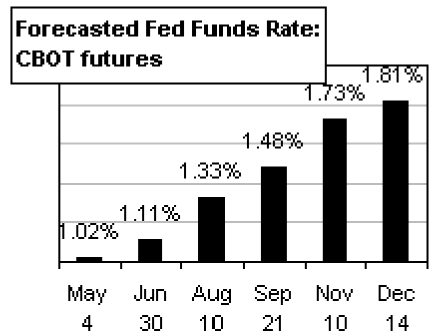
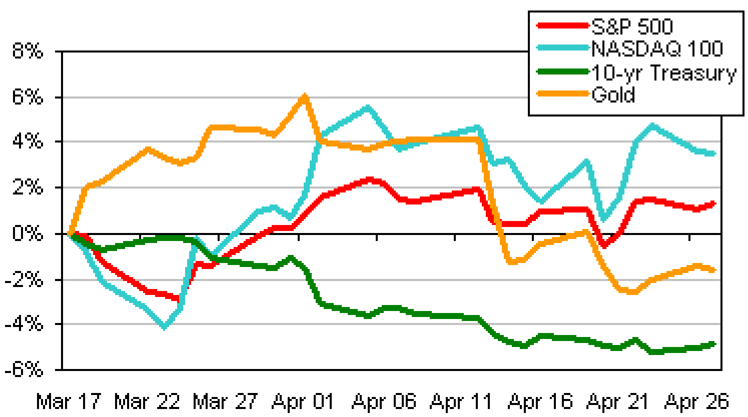
So where's the "buyable dip"? Maybe this is it.



For months we've written about a "buyable dip" coming when the equity market is finally forced to reckon with the reality of an end to **the Fed's** ultra-low engineered interest rates (see "A Buyable Dip" January 29, 2004 and "Buyable Dip? Yes, But..." April 16, 2004). It would seem that the day of reckoning is finally upon us, with futures markets now forecasting something like a steady stream of 25 basis point rate-hikes starting with the August 10 **FOMC** meeting, taking the fed funds rate to at least 1.75% by year-end -- election or no election.

The bond market began sniffing out the impending end of the Fed's "considerable period" of "patient" policy accommodation starting in mid-March, when the yield on the benchmark 10-year Treasury hit bottom at 3.68%. Bond prices have fallen almost 5% since then. But for stocks, so far at least, there hasn't been much of a dip. Over the same period the S&P 500 is almost 2% higher as of yesterday, and the NASDAQ 100 almost 4% higher, despite steeply rising long-term interest rates. Why? Apparently equity markets are smart enough to see the value in a trade-off that gives up the stimulus of easy money in exchange for arresting new inflationary impulses before they get out of hand. Evidence that we will avoid the worst-case scenario of inflationary acceleration can be seen in the fact that gold -- the commodity most sensitive to future inflation risk -- has fallen over the period of rising bond yields.



It looked like the dip we'd been forecasting was going to materialize on Tuesday of last week, when **Alan Greenspan** betrayed a whiff of panic in answering questions after his **Senate Banking Committee** testimony. Greenspan wisely (if belatedly) admitted that deflation was "no longer an issue before us" -- and then unwisely (if honestly) confessed the extent to which this had taken him by surprise, saying "Clearly it is a change that has occurred in the last number of weeks." Stocks fell sharply in the afternoon as investors contemplated the risk of over-reaction by a panicked Fed chairman. The ***Wall Street Journal's*** online edition captured it best, running a story on Greenspan's statement at 1:00 pm with the headline "Greenspan Sees an Economy Evolving Toward Normality" -- and at the end of the day altering the headline on the very same story to read "Greenspan Sees an Economy That May Soon Need Restraint."

By the very next day, though, Greenspan had composed himself. In his testimony before the **Joint Economic Committee** he was the very picture of calm, assuring markets that any policy changes would be gradual and deliberate. The same message has since been repeated by numerous Fed spokespersons. The stock market appears to be placated, leaving us with less of a buyable dip and more of a buyable consolidation. The key message would seem to be that we will avoid crashing against either the Scylla of inflation or the Charybdis of excessive tightening, and instead we have to worry only about removing the temporary crutch of easy money from an economy now expanding rapidly enough to walk on its own two legs.

We are less worried about getting off the crutch than we are about inflation. At this point we are convinced beyond doubt that at least *some* acceleration is absolutely inevitable -- at least 3% core CPI within the next 18 months to two years. Further, we believe that this is not substantially different than the outcome that Alan Greenspan wants (see "What's He Thinking?" March 29, 2004). For the real economy reflected in stock prices, 3% core CPI inflation would not be a disaster. The risk is that it won't stop there, for all the Fed's good intentions. The sad reality is that the Fed's measurement tools and operating procedures are not precise enough to assure any single desired outcome. Even at a core CPI of 3%, bonds will be devastated. A 10-year Treasury yielding today's 4.4% in a 3% core CPI world is inconceivable. Over the last two decades, the typical spread between core CPI and the 10-year yield as been 4% -- *just slightly less than the level of the entire yield today*. Even a considerably lower spread dictates much higher bond yields.

At some point probably not much beyond 3%, stocks would feel the pain too. It's a myth that equity prices are "indexed" by virtue of increases in nominal earnings growth that would track inflation. Even if that were perfectly true overall, it is certainly not true for every individual company -- there would be winners and losers, with considerable risk premia and transaction costs imposed on the entire economy as they got sorted out. It's a fact that equity returns are negatively correlated with changes in CPI inflation. Since 1958, the S&P 500 has returned 19.7% nominal and 15.8% real in years in which CPI inflation fell. But it has returned 4.0% nominal and -0.9% real in years in which CPI inflation rose. TM