TrendMacrolytics

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Quick Takes

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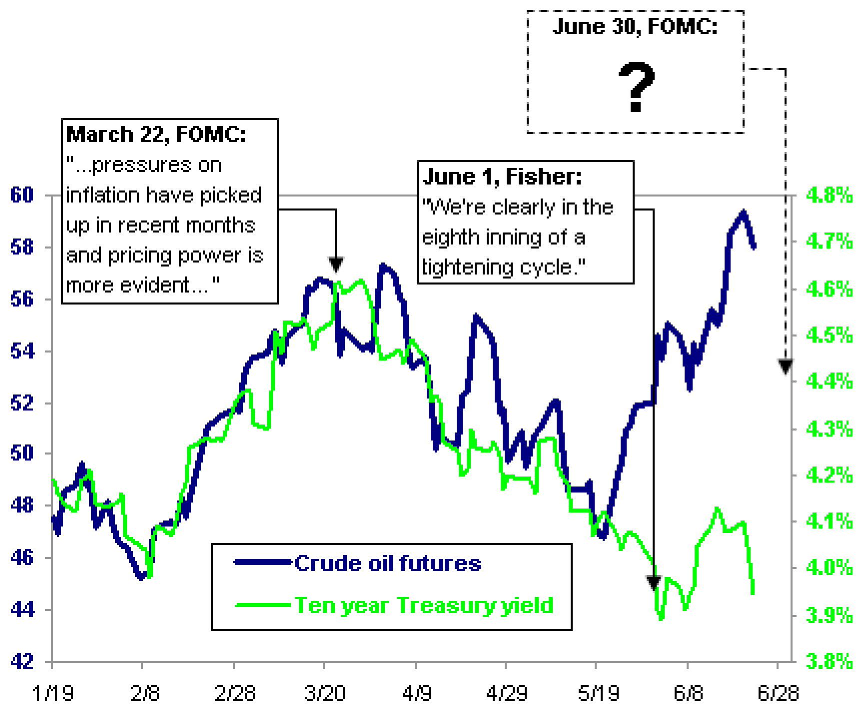
Oil, inflation plays, Social Security, global warming and China.

WITHER THE INFLATION PLAYS? When **the Fed** finally publicly acknowledged the risk of **inflation** at the March 22 **FOMC** meeting, we argued that the surging **crude oil** price had been a wake-up call for the central bank (see "About Time" March 23, 2005). **Treasury yields**, which closely track expectations for Fed **rate hikes** through the end of the year, had seemed to agree, rising along with crude *before* the meeting. But what happened *after* the meeting didn't make sense. The crude price fell, responding to the Fed's apparent commitment to keep hiking rates at a **"measured"** pace. But strangely, Treasury yields fell too -- as though tough talk alone would be enough to deal with the inflationary threat. About a month ago it seems the crude price started to agree with bonds -- that it's all talk -- ultimately rising to this week's all-time highs. Other inflation-sensitive **commodities**, particularly **gold**, have sharply risen over the last month, too (indeed gold came off its recent bottom on the very day that rookie **Dallas Fed president Richard Fisher** said that the current **rate-hiking** regime was almost over). We have another FOMC meeting coming up a week from today. With crude higher than it was in March when it first dialed its wake-up call to the Fed -- and with **Bill ("Dow 5000") Gross** dispending **Kool-Aid** flavored with the prospect of **rate *cuts*** this year -- the Fed has an important opportunity to make it clear whether or not it's decided to hit the snooze button.



As we've pointed out several times before, when the oil price is at issue the Fed's decisions carry special risk (see "The Fed's Oil Slick" March 21, 2005). The FOMC's recent statements emphasize the growth risks inherent in rising energy prices, and soft-pedal the inflationary causes and consequences of those prices. This leaves open the possibility of repeating the monetary errors of the **1970s**, in which policy was kept loose to accommodate rising oil prices -- stimulating the inflation that caused oil prices to rise in the first place. Against this background of rising inflation risk over the last three weeks, some of the **inflation plays** in the stock market

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have come back to life to various extents. Obviously the **Energy Sector** has -- very much so. More subtly, **small-cap** has outperformed **large-cap** a bit, and **Information Technology** has slightly lagged the broad market (we believe that the **small stock premium** is positively sensitive to inflation risks, and that growth-oriented stocks are negatively sensitive). We're not ready to declare the rebirth of the inflation plays just yet, having declared them dead in late March (see "The End of a Theme" March 29, 2005). There's still room for the Fed to get it right, and for the bond market to be wrong. But we're on high alert.

SOCIAL SECURITY REFORM: RIP It's a sad sign of the times that the *good* news on **economic policy** this week is **President Bush's** signaling that he would support a **Social Security** bill in the **Senate** that did *not* include **personal accounts**. That's probably the *coup de grace* for reform. What's good about it is that it pretty much eliminates the threat of raising the **payroll tax wage cap** -- so that's one huge **Sword of Damocles** no longer hanging over the **equity market**. Perhaps that's one reason why the mass of stocks has continued to gradually creep consistently higher over the past two months -- unheralded, the **Russell 1000** is back to within basis points of new highs for the year, at levels not seen since mid-2001.

BACK TO BASICS, BUT NEW RISKS Moving on from Social Security reform allows **President Bush** to redeploy what's left of his political capital, and to try to rein in a **Republican majority** that seems to have seriously lost its way on economic policy. The **White House's** "talking points" memo yesterday listed reform dead last among "economic security" priorities -- all year, until now, it had been number one. Suddenly number one now is passage of an **energy bill**. But that is not without its risks. Bipartisan support in the Senate is developing for a **carbon tax** to be added to the energy bill, aimed at combating **global warming**. The call for such a tax comes not only from our own **environmentalists** and **internationalists**, but from **Europe** as well (**Britain's Tony Blair** has been personally lobbying **US** legislators about it, and it is expected to be a big topic at the upcoming **G8 meeting**). Depending on exactly what form the tax might take, it could potentially be an economic catastrophe of unprecedented magnitude -- not only acting through the direct money taxation of emissions, but also through the astronomical opportunity cost of requiring our economy to consume less energy). The White House is opposed to such a tax, or anything else but voluntary emission reductions. It explicitly recognizes Europe's urgings as a form of beggar-thy-neighbor **mercantilism**, aimed at getting **America** to foot the bill for a problem that is decidedly *not* America's problem (if it's even a problem at all). For all of America's super-sized **fossil fuel** consumption, our remediation technology is among the most advanced among major nations and our heavily forested continent is a very effective carbon sink -- so the American landmass actually absorbs more carbon emissions than we produce, on net. Count the risk of a carbon tax as a new Sword of Damocles. But thankfully, with Social Security reform no longer held hostage in the Senate, the White House has considerably more scope to discipline any Republicans who might support the carbon tax.

CHINA RISK The other big Sword of Damocles still overhanging the economy is the continuing risk of passage next month of the **Schumer/Graham bill** that would impose a 27.5% tariff on any goods entering the country from **China**, unless China revalues the **yuan**. From our vantage point it seems that the calls for revaluation have become fewer and less strident over the last few weeks (with the **euro** suddenly so weak relative to the **dollar**, to which the yuan is pegged, Europe has gone positively silent on the matter). That's good -- because if China is to tweak its exchange rate regime and thereby head off Schumer/Graham, it must be able to make it look like it's its own idea. Perhaps one hint that this is exactly what's in store was the publication last week in a Chinese newspaper of an op-ed commentary by an official of one of the state-owned banks, calling for widening the peg's band by 3% to 5%. That said, with two proposed **acquisitions** of American companies by Chinese ones in the news this week, isolationist and protectionist fears of China taking over the world are likely to cause the revaluation talk to get louder and tougher. Logically though, a revalued yuan would only make it easier for China to acquire US assets. And the fact that the acquisitions are happening *now* suggests, all else equal, that the Chinese currency is already anything but weak. In truth, it's **US equity valuations** that are weak -- not the yuan. The Chinese are simply doing the last good **carry trade** remaining: swapping US **Treasury bonds** for US **stocks** (see "The King of Carry Trades" June 14, 2005). Quite a far cry from what the similarly situated **Japanese** did two decades ago -- **Maytag** and **Unocal** are far better deals than **Pebble Beach**. TM