TrendMacrolytics

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

MACROCOSM

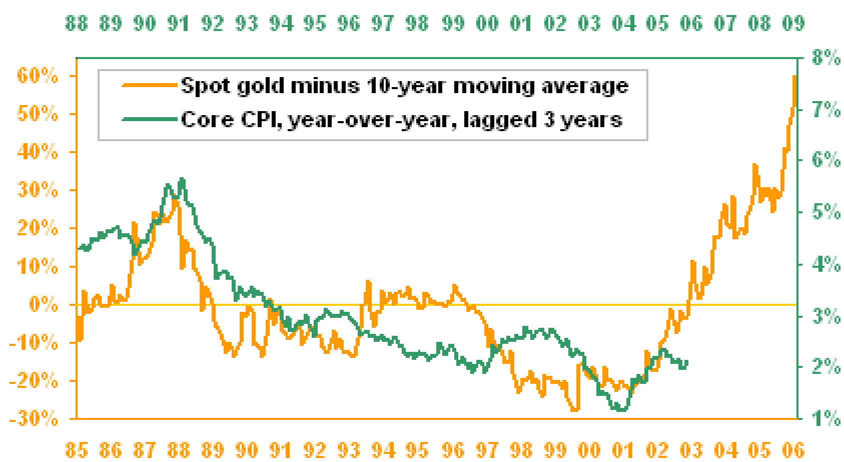
Accidentally on Purpose

Wednesday, January 11, 2006
Donald Luskin

How the stock market and the Fed are getting it right by getting it wrong.

There are any number of good reasons to be positive on **equities**. The idea that **the Fed** is **"done"** hiking interest rates isn't one of them. Be long here for the reasons we've been talking about for the last year -- deep **undervaluation** of equities relative to surging **earnings** and low competing **bond yields**, against a backdrop of sustainable **economic growth**. But have no illusions. The Fed will not be done at a **funds rate** of 4.5% at the month-end **FOMC** meeting. When the **stock market** gets the message, it will come *un*done, to the extent it's been relying on a misreading of the Fed.

We could say that stocks at better than four-year highs are doing the right thing for the wrong reason. And our conviction that the Fed isn't done is based on much the same idea. While there are plenty of good reasons why the Fed should keep **hiking rates**, the Fed will rely on the wrong reasons to end up accidentally doing the right thing.



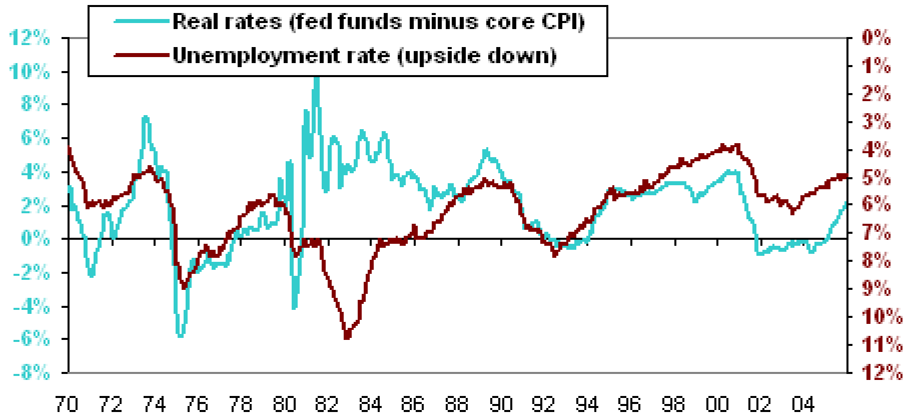
Clients know well what we think the right reasons are. Forward-looking market-based **price signals** from **inflation**-sensitive **spot markets** -- **gold** and other **commodities** (by rising) and the **forex** value of the **dollar** (by falling) -- have all registered heightened inflationary risks over recent weeks as speculation that the Fed is done has intensified. The risks are not cataclysmic in their potential scope, but they are significant. Gold, now at new recovery highs and 60% above its 10-year moving average, is expressing inflationary expectations in relation to the existing **price level** that have historically been associated with a 5.5% **core CPI**, based on robust **regression analysis**. There was a time more than a decade ago when **Alan Greenspan**, as well as Fed governors **Wayne Angell** and **Manuel Johnson**, would have been very responsive to such an alert -- but those days are gone. Last April, amidst unfounded fears of an economic "soft spot," Angell called "all clear" on the commodities inflation alert, rationalizing his view by noting that, at that time, a diversified **basket** of commodities had shown no price increase year-over-year (see "Inflation: Disagreement Among Friends" April 26, 2005). Angell had to drop **oil** out of the basket to make that statement true (*with* oil, the basket as represented by the **CRB Futures Index** was up 11.4% year-over-year at that time). Today, the oil-free basket (as represented by the **CRB Spot Index**) is no longer flat year-over-year -- it's up 5.9%. And with oil, it's up 24.0%. We don't know what Angell is thinking at this point, but it would

http://www.trendmacro.com
don@trendmacro.com
dgitlitz@trendmacro.com
tdemas@trendmacro.com

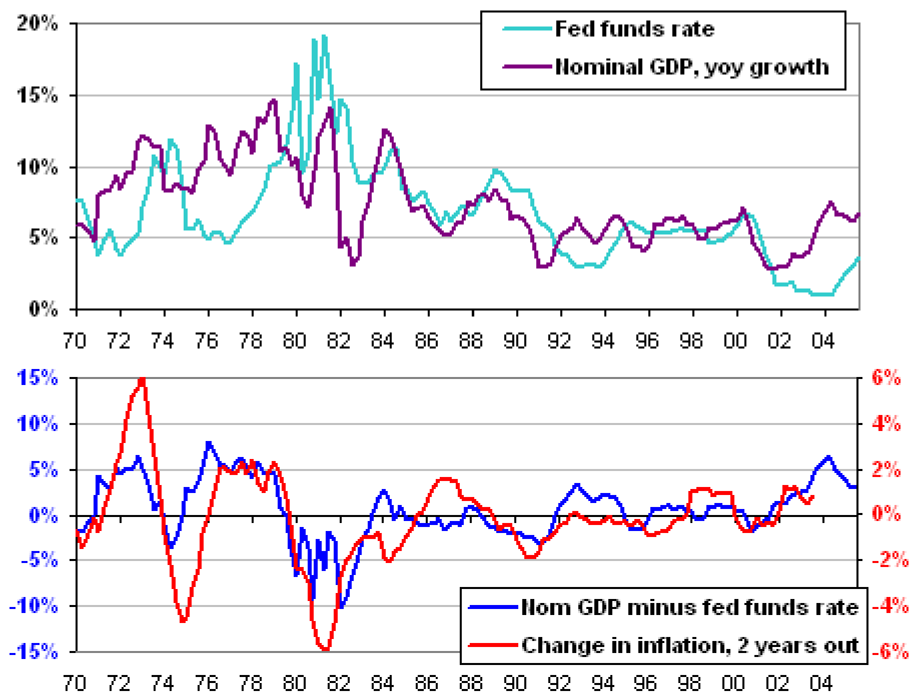
Offices:
Menlo Park CA
Parsippany NJ
Charlotte NC

Phone:
650 429 2112
973 335 5079
704 544 6900

seem his **dovish** rationale of last year no longer holds. Is incoming Fed chairman **Ben Bernanke** aware of the risks that commodities are signaling? We believe he is -- but it's in his peripheral vision, at best.



The Bernanke Fed is more likely to be moved to keep hiking rates by what we believe are the wrong reasons. These reasons are connected to the **neo-Keynesian "output gap" IS-LM model** that rapid **growth** and **full employment** either cause or are caused by inflation -- either way, if the economy continues to grow as we expect it will, the **policy** prescription will be **tightening**. As the chart above suggests, we are already at the low limit of **real interest rates** (proxied here by the fed funds rate minus year-over-year core CPI) likely to be tolerated by the Fed in light of the present **unemployment rate**. As the unemployment rate drifts lower through 2006, as we believe it will, the Fed's models will pressure them to move real rates higher by continuing to hike the fed funds rate.



Here's another way of making the same point. The upper panel of the chart at left shows **nominal GDP growth** and the fed funds rate, and the dark blue line in the bottom panel shows the difference between them. Note that except for a single month in 1992, the funds rate has not been lower relative to nominal GDP growth than it is today since the late 1970s. There has not been a sustained period like this since the early 1970s and the late 1970s. This suggests that we are at the upper bounds of the Fed's tolerance for growth. We believe that growth will continue, so for this relationship to move back into normal bounds, it's the Fed that's going to have to do the moving -- by continuing to move the funds rate higher.

The reason for this exercise from the Fed's point of view -- the wrong reason, we believe -- will be to brake growth before it moves into the realm the Fed's models regard, oxymoronically, as **"above capacity."** A right reason for doing the same thing would be to recognize the inflationary **arbitrage** made possible by a funds rate that is too far below **potential returns** available in the economy, as proxied by nominal GDP. When potential returns are high in relation to **borrowing costs** held artificially low by the Fed, the Fed will have to create **money** to accommodate marginal borrowers who wouldn't otherwise be in the market. The consequences are excess money creation, and eventually inflation. As the bottom panel of the chart above shows, the difference between nominal GDP growth and the funds rate is an excellent predictor of the future direction of change in the inflation rate (here represented by the red line, and measured as the implicit GDP deflator). This supports our view that no matter what the Fed does now, we are virtually destined to experience higher rates of inflation based on nothing but past policy. The Fed's challenge now is to keep inflation from exceeding the predestined level already in the **pipeline**.

Whether for right reasons or wrong reasons, there is a strong basis to be confident that the Fed is aware of the importance of that challenge. Remember, less than six months ago Alan Greenspan admitted in a speech at **Jackson Hole** that a "risk management" philosophy had moved the Fed, in the summer of 2003, to counter "consequential deflation" with "unusually low interest rates" despite "the higher inflation that might ensue." Ben Bernanke was there for that decision -- indeed he had laid the foundation for it with his own earlier speech about the Fed's "printing press...that allows it to produce as many U.S. dollars as it wishes at essentially no cost." Bernanke was speaking loosely -- he didn't mention that the cost is inflation. He no doubt regrets the flamboyance of that statement, and is very well aware of the cost.

Bottom line: We continue to expect the Fed to raise the funds rate to 4.5% at the January 31 FOMC meeting, and to 4.75% at the March 28 meeting. Between the two meetings we expect unmistakable emanations from the new Bernanke Fed disabusing the market of the notion that it is done. When that happens, stocks -- to the extent that they have been moved by incorrect expectations that the Fed is done -- will come undone, especially the inflation plays (the recent move in gold, commodities and the dollar having been overdone). At this time our guess is that a large negative reaction by stocks would be a buying opportunity, as continuing to hike rates to the upper end of **neutral** -- say, 5% -- would be a salutary and barely-in-time inflation-fighting move that will enhance the current expansion's sustainability. TM