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Today and 1987: Ominous Parallels? Part 2

Friday, June 2, 2006
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The worst thing the Fed could do now is to repeat Greenspan's 1987 mistake.

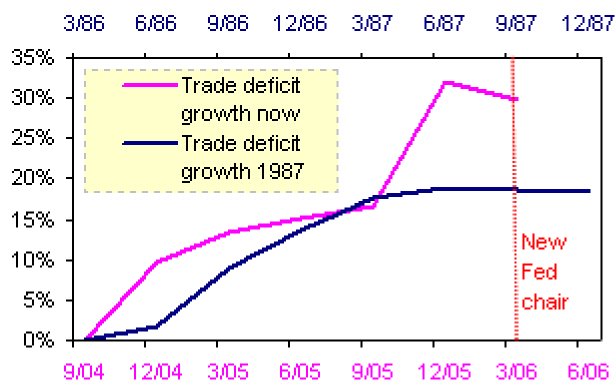
Last week we began an examination of the seeming similarities in the economy and the markets between 1987 and today (see "Today and 1987: Ominous Parallels? Part 1" May 25, 2006). We noted that, other than the stock market crash, economic performance was excellent during 1987 and the two years after -- so we fundamentally question why similarities between today and 1987 should be alarming. And we noted that the 1987 crash was made possible by a near-historic imbalance in the equity risk premium, with stocks extraordinarily overvalued relative to Treasury yields and forward earnings. That imbalance today exists in reverse, although not quite to the same level of extremity -- thus bonds are vulnerable here, not stocks.

Update to strategic view

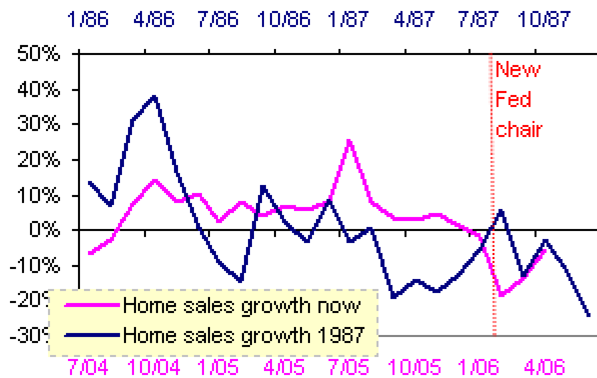
STOCKS: A Fed operating *ad hoc* is a recipe for stock market volatility. But the inflation-aware Fed portrayed in Wednesday's FOMC meeting is almost certain to do the right thing and keep raising rates, regardless of this morning's soft jobs report. Thus the recent sharp drop in stocks emerges as a buying opportunity.

This week we will look at the parallels in particular macroeconomic variables between 1987and today. We conclude that some parallels are unimportant. The most salient ones are the inflation warning signals from leading market-based indicators -- such as gold and the foreign exchange value of the dollar -- and the upturn in lagging statistical measures of inflation -- such as the Consumer Price Index -- following long periods of falling. In 1987 these turned out to be precursors to later extreme monetary tightening by the Fed, which triggered the 1991 recession. The critical question in today's context is whether we are destined to repeat that experience.

SOME MACRO PARALLELS ARE UNIMPORTANT Some observers have pointed out that the United States experienced large growth in the trade deficit in 1987, and has done so again recently. The chart at right compares the 2-year period encompassing 1986 and 1987, overlaid on the present 2-year period and aligned on the arrival of a new Fed chairman (Greenspan then, Bernanke now). It shows percentage growth in the trade deficit, cumulative for the timeframes viewed. The expanding trade deficit was a matter of great public alarm in 1987, based on greater than 15% growth that had occurred in 1986 -- though there was no additional growth in 1987 itself. This time around, after the same initial 15% growth, we've seen the deficit grow by another 15%. This leaves the trade deficit twice as large today as it was in 1987, as a percentage of GDP. It's a big number, to be sure -- one that excites public passions, and has the potential to stimulate

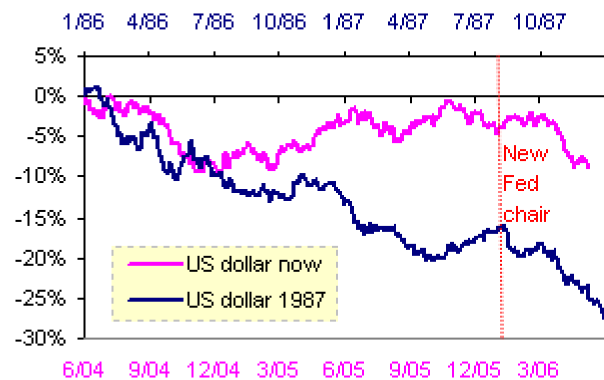


anti-growth protectionist measures. But other than such spillover effects, we don't regard the trade deficit to be a high-impact economic variable -- then, or now (see "Trade Deficit Hokum" June 21, 2002).

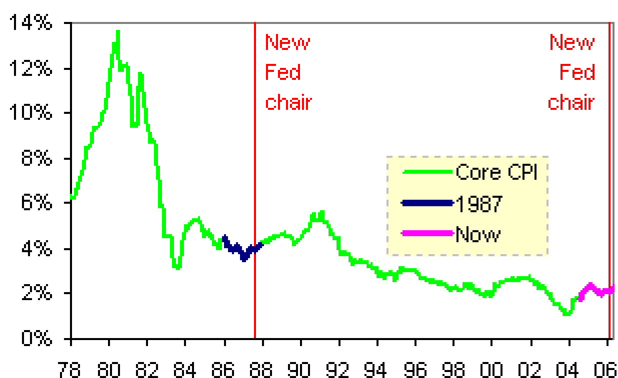


It has also been noted that the housing market was cooling in 1987, as it seems to be today. The chart at left shows year-over-year growth in new home sales for both periods. The present cooling is from a consistently higher level, versus a choppy growth environment in 1987. So while the cooling then doesn't seem to have led to inferior overall growth, today's cooling potentially represents a greater threat. But we don't believe that housing has been in a "bubble" in any broad sense, and so don't expect any deep dislocations from a cooling (see "Housing Bubble Bunkum" August 16, 2005). To the extent that the recent housing boom has been what Alan Greenspan once called an "imbalance," we would regard an orderly unwind as a positive.

INFLATION IS THE KEY VARIABLE Most observers of the "ominous parallels" have pointed out the similarity of this year's drop in the foreign exchange value of the dollar following Ben Bernanke's arrival as Fed chair to that of 1987 following Alan Greenspan's arrival. The chart at right shows the change in the value of dollar versus a trade-weighted basket of major currencies, then and now, cumulative over the timeframes viewed. Clearly the drop in the dollar post-Bernanke is small compared to the drop post-Greenspan. And the present drop follows a year of broadly climbing dollar value, while in 1987 the sharper drop followed on what was already a year and a half of heavy and persistent decline.

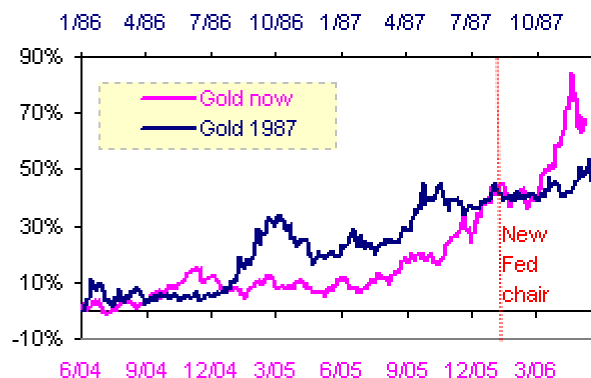


Nevertheless, today the record trade deficit seems to have put market participants in a mood to regard the present mild decline as an incipient "dollar crisis." We don't see it that way. In our worldview, the value of a currency has little to do with a nation's trade or fiscal deficits, and everything to do with its central bank's monetary policies. When a central bank is too accommodative for too long (at least versus the policies of other nations' central banks), then its nation's currency will decline in relative value. Indeed excessive accommodation leads a nation's currency to decline in relation to all things, not just foreign currencies. In other words, it leads to *inflation*. It is *inflation* that is the most ominous parallel between 1987 and today.



The chart at left shows year-over-year change in the core Consumer Price Index since 1978. The two 2-year periods we have been examining are highlighted in contrasting colors. Both new Fed chairmen took office during periods of rising core CPI. Greenspan took office midway during a long "bear market rally" in inflation following its sharp fall from its peak in 1980, the rally spanning almost eight years from August 1983 to February 1991. Bernanke took

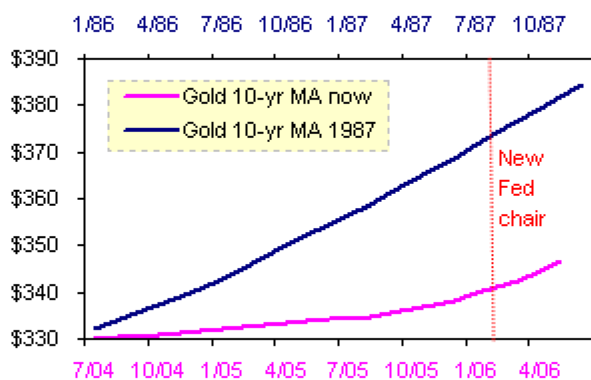
office about two years after core CPI had hit bottom at just above 1% in December 2003.



There is good reason to believe today, just as there was in 1987, that the already rising core CPI will continue to rise -- and that today, as then, the Fed will have to do something about it. The falling value of the dollar is one piece of evidence. Another is the rising prices of commodities, especially gold, the most monetary commodity. These prices give us the purest view of contemporaneous inflationary dynamics, without disguise by the complex web of "sticky" prices in the overall economy. The chart at right shows the change in the spot gold price during the two 2-year periods, cumulative for the timeframes viewed. In both periods the gold price had risen by more than 40% by the time the new Fed chair took office. Following Greenspan, gold rose another 10% -- but following Bernanke, gold rose another 40%. This tells us unambiguously that contemporaneous inflationary impulses are stronger today than they were in the 1987 period.

Dangerously, today's inflationary impulses are masked by a variety of factors, allowing Fed officials to have complacently repeated for many months that "inflation and inflation expectations are contained." *First*, for all the alarmed talk about today's dollar weakness, its true severity been lessened by the offsetting too-easy policies of the European Central Bank and the Bank of Japan. Notably, this is precisely the opposite of what happened in 1987, when dollar decline was exaggerated by the too-tight policies of the BOJ and the Bundesbank.

Second, today's strong inflation impulses have failed so far to show up clearly in measures of the general price level, such as the Consumer Price Index, because they are being offset by residual *deflationary* impulses from the Fed's too-tight regime of the late 1990's and early 2000s. Here, again, we have the precise opposite of what happened in 1987, when the general price level still contained residual inflationary impulses from the hyperinflation of the late 1970s and early 1980s.



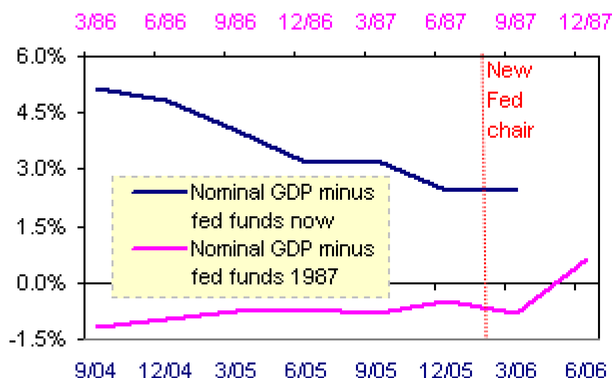
One way to quantify this interaction of contemporaneous and residual price impulses is by thinking of the 10-year moving average gold price as a proxy for the overall price level. The 10-year moving average gold price is a mixture of old and new price information, just as the overall price level is a mixture of rapidly changing contemporaneous prices and deeply embedded "sticky" prices that take years to roll off. The chart at left shows the 10-year moving average of gold for the two 2-year periods. Even though, contemporaneously, gold has risen far more dramatically today than it did in 1987, the 10-year moving has been rising much more slowly -- just as the Consumer Price Index has been rising more slowly, and for the same reason. Today the 10-year moving average gold price still has deflationary sub-$300 prices in it left over from the deflation of the early 2000's -- in 1987, it still had hyperinflationary $800-plus prices left over from 1980. Then, as those old high prices rolled off to be replaced by lower new ones, the 10-year moving average had to turn down -- just as CPI growth had to decelerate. Today it is just the opposite. Older low gold prices will eventually roll off, to be replaced by new and far higher ones. As that happens, the 10-year moving

average gold price will accelerate, and CPI growth will too. As the steepening slope of the 10-year moving average gold price in the chart suggests, the process is well underway.

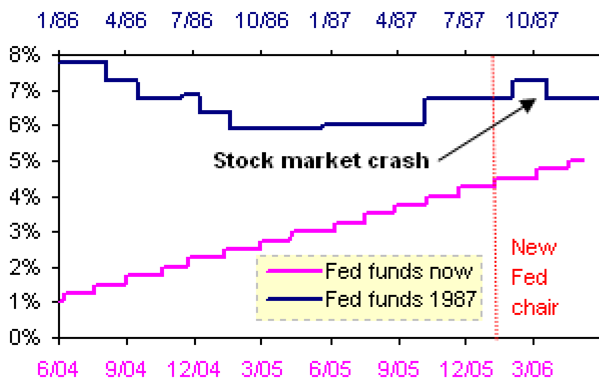
Over the last 35 years, the slope of the 10-year moving average gold price has been highly correlated to year-over-year changes in core CPI (the r-squared of the linear regression equation is 0.76). The *predicted* value for core CPI based on today's slope is 2.3% -- exactly the same as the *actual* value. In order for the equation to predict no greater CPI growth a year from now than it does today, the spot gold price would have to fall below $500 immediately and stay there for the next 12 months. Happily, as the Fed has pulled back from the inflation complacency Bernanke expressed to Congress in his testimony in late April -- admitting in the FOMC meeting minutes released Wednesday that inflation expectations are no longer quite as "contained" as they used to be -- we're already almost half-way there from gold's recent highs above $700.

NOT REPEATING THE FED'S 1987 MISTAKE

We have long maintained that the Fed should (and would) continue to hike interest rates at each FOMC meeting, without pause. The goal would be to reach "neutral" -- an at-market level, at which rates would no longer be subsidized by the Fed so far below the rates of return available in the economy. The chart at right shows the difference between year-over-year nominal GDP and the fed funds rate, over the two 2-year periods. In 1987 we can see the Fed is gradually loosening, by letting an increasing wide gap develop between the cost of funds and the opportunities available in the economy. In the current period we see that gap narrowing, so the Fed is indeed tightening. But the Fed has moved slowly -- at only a "measured" pace -- and so rising rates have so far failed to catch up with an economy that has grown faster and more consistently than most expected. Thus rates today at 5% don't make the Fed a whole lot tighter than it was last year when rates were at 4%, and so contemporaneous inflation impulses have yet to be mastered. The longer the Fed waits, the more of those inflationary impulses will enter the overall price system, just as older far lower prices from the deflationary late-1990s roll out of the calculation. So the Fed must not pause -- indeed, we were heartened to learn from Wednesday's FOMC minutes that a 50 basis point hike had at least been considered at the last meeting.



In1987 the Fed did more that pause in its then-current rate-hiking regime -- it cut rates, as shown in the chart at left, displaying the fed funds rate over the two 2-year periods. The catalyst for it was the October 19, 1987 crash. New Fed chair Alan Greenspan became a hero for giving the markets sufficient liquidity to be sure that seized-up post-crash markets could clear. But his mistake was going beyond what was necessary for that, by also providing additional liquidity to preemptively buffer what were assumed would be serious negative macroeconomic consequences of the crash. This was a mistake because the crash was largely the result of technical and valuation factors, and was thus unlikely to have important macroeconomic consequences in the first place (again, see "Today and 1987: Ominous



Parallels? Part 1" May 25, 2006). To the extent that, as some historians have argued, the proximate trigger of the crash was fear of an imminent dollar crisis provoked by loose remarks by Treasury secretary James Baker, Greenspan's lowering interest rates was precisely the wrong thing to do.

The consequence of Greenspan's mistaken rate cut was to let the Fed fall behind growing inflationary impulses, as evidenced by the fact that the dollar went lower, and gold higher, after the crash. The most "ominous parallel" to today is the possibility that Bernanke will repeat Greenspan's mistake, perhaps egged on by the steep drop in stock prices over the last three weeks -- misinterpreting it either as a forecast of a sharp slowdown in economic growth already underway, or of the market's fear that further rate hikes could trigger such a slowdown. In 1987, Greenspan's mistake meant that he ultimately had to raise the fed funds rate to a crushing 9.75%. We continue to believe that, today, if the Fed does not pause, that rates no higher than 6% should be sufficient to master current inflationary impulses. Such a level need not be an inhibitor to growth. Indeed, 6% is only 12.5 basis points higher than the *low point* in the rate cycle that began just before Greenspan took office in 1987.

Stocks got into trouble over the last month following Ben Bernanke's congressional testimony in late April suggesting a premature end to this rate-hiking cycle and revealing considerable complacency about inflation -- followed by his apparent recanting of that view just days later via Maria Bartiromo. That was a double-whammy: a Fed that fails to urgently prioritize inflation risk, and that can't get its story straight. The minutes released on Wednesday seemed to be the antidote to that: a Fed that was properly focused on inflation as Job One, within a diverse mix of views about the importance of other economic risks. We think the strong upside reaction of stocks following the release of the minutes was an affirmation that a more hawkish Fed is a good thing for the quality and the longevity of the present expansion -- and that a Fed that clearly communicates its priorities is better still.

As of this writing, following the release of a disappointing payroll jobs report this morning, stocks have not exactly celebrated what is being touted as a new reason for the Fed to change its mind once again and end up pausing at the June 29 FOMC meeting. If the conventional wisdom were right -- that stocks want the Fed to be done right here and right now -- then stocks would have fallen yesterday and soared today. But just the opposite has been the case -- because anything that moves the Fed toward pausing also moves the Fed toward repeating Greenspan's mistake of 1987.

BOTTOM LINE: Stocks appear to be moved in the short term by the conventional wisdom which fears that continued Fed rate hikes will slow the economy. We believe the reality is quite different -- that continued orderly rate hikes are necessary to blunt current inflationary impulses, and thus enhance the quality and the longevity of the present expansion. The last two years have been marked by intermittent panics reflecting the temporary ascendancy of the conventional wisdom's fears, every time eventually giving way to the truth that higher rates and continued growth go hand in hand. We regard the recent sharp drop in stock prices as another one of those panics -- aggravated by the new uncertainties generated by the way the Fed has made it so painfully clear that there is significant divergence of opinion among its policymakers, and that its decisions will be "data dependent" -- which is functionally a euphemism for *ad hoc*.

An *ad hoc* Fed is a recipe for equity market volatility, and that's unfortunate. Still, at this point there is no going back from the hawkish inflation-aware Fed portrayed in the FOMC minutes released Wednesday. By confessing that inflation expectations are beginning to become less well "anchored," the Fed has committed itself to a course of doing something about it -- because we are sure that the inflation data to come isn't going to let the Fed off the hook. And either is this morning's soft payroll report, the bond market's wishes notwithstanding. The *ad hoc*

approach is yielding the right answer -- no pause. Therefore the sharp drop in stock prices over the last month is emerging as a buying opportunity.

It must be said, though, that we do continue to be concerned that the Fed will do the right thing in part for the wrong reason -- out of fear that the economy is "overheating" (see "Right Thing, Wrong Reason?" June 1, 2006). Such reasoning begs the eventual question of what will ever *stop* the rate hikes, short of a slowing economy. Against that risk, the Fed's *ad hoc* approach and the present divergence of views among policymakers -- some of whom are very eager to "do no harm" by raising rates from what they see as already near-"normal" levels -- may end up being a good thing: preventing the worst excesses of overshoot. But there's no escaping the reality that the risk of serious Fed error is greater now than it has been at any time in the last three years. It's a good time to be in the Fed-watching business. TM