TrendMacrolytics

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MACROCOSM

The May 10 Inflection Point

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It was the high water mark of inflation expectations and carry trades -- but it's a mistake to think it's going to roll the economy over.

It is now clear that May 10, 2006 -- the date of the most recent FOMC meeting -- was an important inflection point for markets. On or near that day market-based indicators of inflation expectations rolled over. Asset classes, sectors and styles that had been the best performing -- all carry trades in one guise or another -- violently reversed. Broader macroeconomics-sensitive asset classes have also fallen.

For the umpteenth time in what has been a remarkably powerful and consistent economic expansion and bull market in equities, the conventional wisdom has yet again become virtually certain of an impending slowdown. *We say again now what we've said each time this has happened since early 2003: the conventional wisdom is wrong.* Interest rates are nowhere near prohibitive levels relative to historical norms, rates of return available in the economy, or inflation. The Fed's renewed focus on inflation takes an important risk off the table. Tax rates on capital are the lowest in generations, virtually locked in through 2010. The risk-capacity of the economy remains vibrant. Forecasted earnings continue to soar. And stocks are cheap.

INFLATION EXPECTATIONS TURN THE CORNER Though the May 10 FOMC statement seemed superficially dovish in that it repeated the mantra that "inflation expectations are contained," we nevertheless wrote that day that the "statement was more hawkish than many anticipated" (see "On the FOMC Meeting" May 10, 2006). Our advice to the Fed at that time had been that it was putting its credibility at risk by denying the plentiful evidence that inflation expectations were *not* "contained" (see "Lesson Learned?" May 3, 2006). Sure enough, when the minutes of the May 10 FOMC meeting were released on May 31, there was a confession that "inflation expectations…had moved up," and a defensive-sounding rationale for having said otherwise in the meeting's statement. And in a speech last Monday, Ben Bernanke removed any remaining ambiguity when he said that the Fed's mission was "anchoring the public's long-term inflation expectations."

Update to strategic view

US MACRO: The expansion is not at risk from the Fed driving interest rates to the equilibrium levels sufficient to quell inflationary impulses and expectations. By doing a little now, the Fed probably avoids having to do too much later.
US STOCKS: The carry trade sectors that were "what's working" have stopped working, and stocks overall have fallen victim to unwarranted spillover pessimism. The recent dip is a buying opportunity.
US SMALL CAP: As the Fed follows through on its inflation offensive, the small stock premium will continue to disappoint, even as the broad stock market recovers.
US RESOURCE STOCKS: Continued global growth and inflation already in the pipeline put a floor under nominal resource prices. But with the ramp in inflation expectations at an end, these sectors will disappoint.
US BONDS: The "slowdown" bet in long-term bonds that has the Fed "one, done, and ease" is a loser, yet again.

[see Investment Strategy Dashboard]

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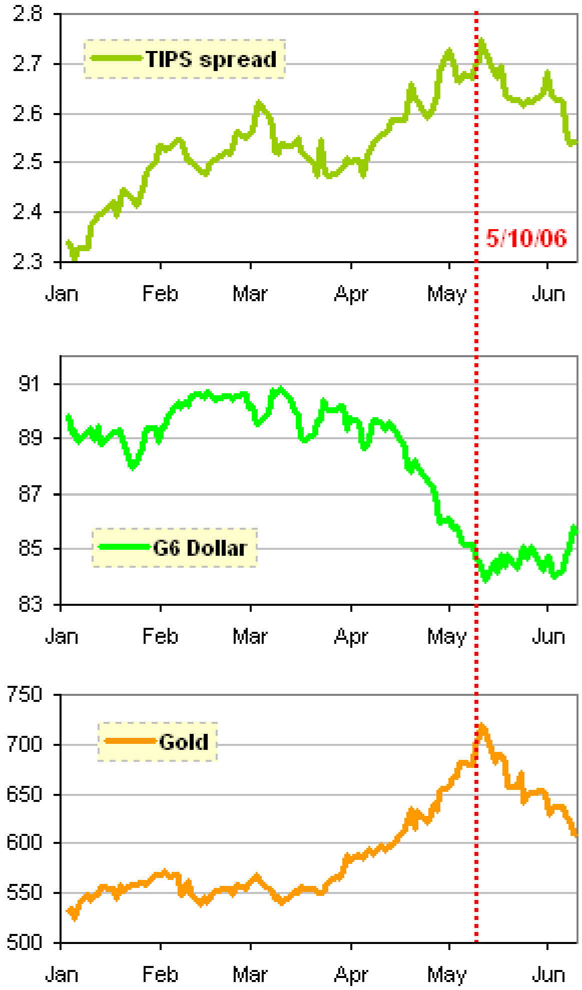
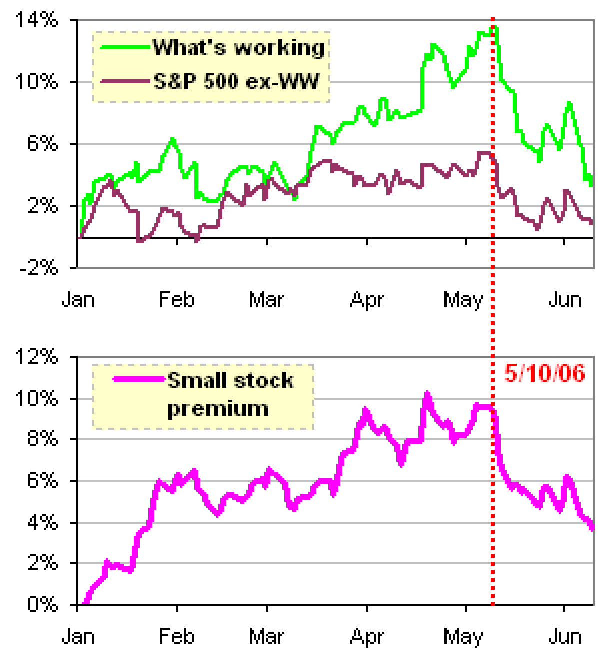
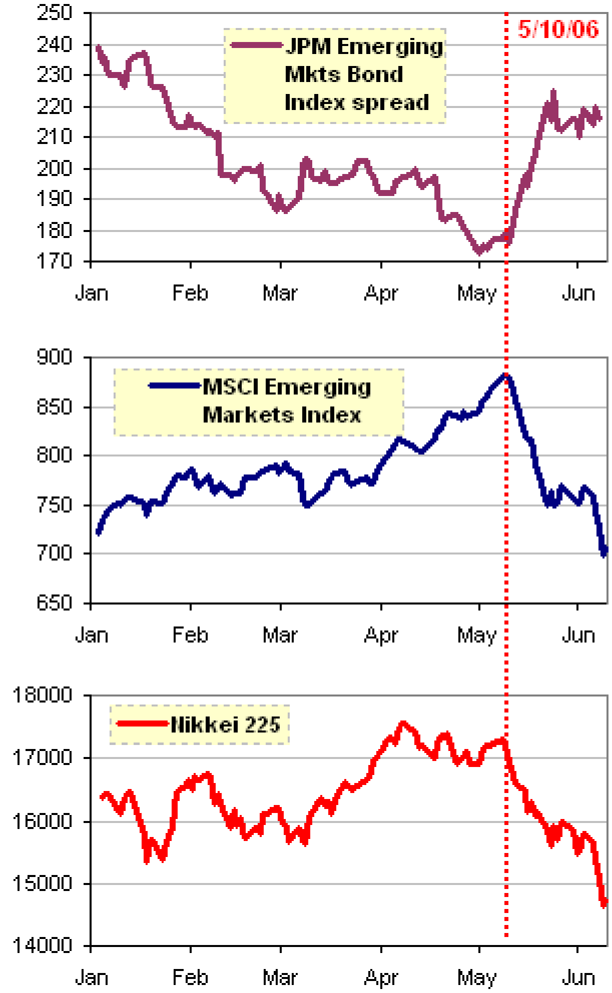


May 10 now looks like the high water mark for expected inflation. Lagging official measures of inflation such as the Consumer Price Index will continue to rise as they reflect inflationary impulses embedded by the Fed over the last several years -- a statistical artifact that carries its own brand of policy risk (see "Bernanke Arrives" June 6, 2006). But forward-looking market-price indicators of inflation -- the most accurate gauges of whether the Fed is supplying an inflationary excess of dollar liquidity -- have turned the corner. We believe the turn is decisive, because the Fed has so clearly taken public note of these indicators in the last two weeks. Bernanke and other Fed officials have publicly admitted their awareness of the dramatic rise in the TIPS spread this year, and the symmetrical drop in the foreign exchange value of the dollar. Loosely speaking, and for the time being, that means these indicators are being "targeted" by the Fed. By our lights, this is almost precisely what the Fed should be doing -- targeting inflation-sensitive spot prices, not interest rates. Of course gold -- the most monetary spot price of all -- has given the clearest signal of all. But in public the closest the Fed will come to acknowledging the barbaric relic is to fret about potential inflationary feed-through from "elevated commodities prices." It's a start.

"WHAT'S WORKING" STOPS WORKING As long as the Fed is targeting expected inflation, short-term rates are headed higher, commodities are headed lower, and the dollar is headed higher -- so the "carry trades" or "inflation plays" driven by excess dollar liquidity that have been "what's working" for the last two years have hit a dead end.



This probably goes a long way toward explaining the sense of distress we're picking up from investors, seemingly out of proportion to the minor correction experienced in the broad stock market this last month. From the bottom in October 9, 2002, through May 10, the S&P 500 total return was 81.6% -- a real bull market by any standard. Since May 10, the loss has been a mere 5.2%, hardly the stuff of major hand wringing. During this bull market there have been four declines of greater magnitude, and four others of about the same magnitude. But this time around, the inflation plays -- crowded longs all -- were especially hard hit. In the S&P 500, three of the four *best* performing sectors year-to-date through May 10 -- Energy,



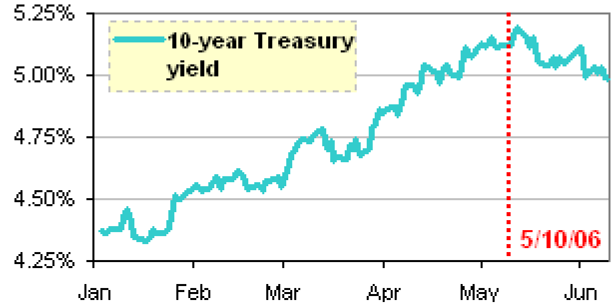
Basic Materials, and Industrials -- were three of the four *worst* performing sectors *after* May 10. Those three sectors combined have lost 9.1% since May 10, while the S&P 500 with those sectors removed has lost only 3.2%.

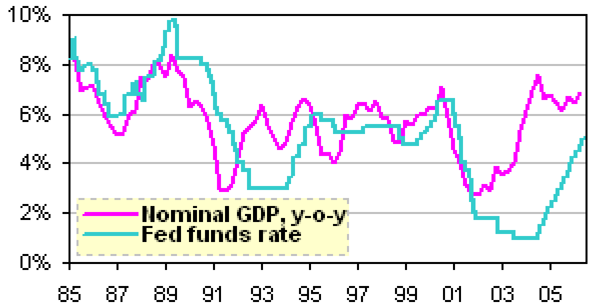
Similarly, the seemingly one-way trade in small cap stocks has strongly reversed in the month following May 10. The small cap Russell 2000 had outperformed the large cap Russell 1000 by almost 9% year-to-date as of May 10. Since then, it has underperformed by almost 5%. One doesn't necessarily think of the small cap premium as being associated with inflation, but it is. Over the last forty years, the outperformance of large cap stocks by small cap stocks has been closely correlated with rising inflation and inflation expectations, and underperformance has been closely correlated with falling inflation and inflation expectations.

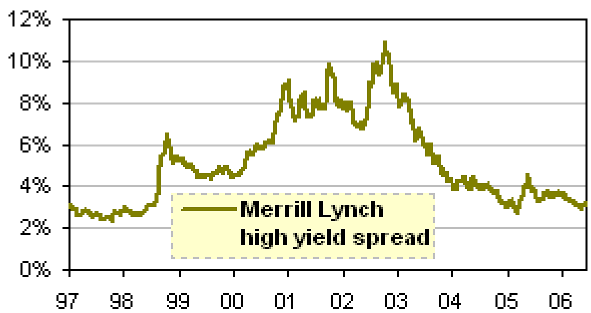
Crowded emerging markets plays have been especially hard hit, too. In a matter of days following May 10, emerging market bond spreads gave back two thirds of their year-to-date gains. Down almost 20% since May 10, emerging markets equities have given all of their year-to-date gains. Japan, a mature market -- though one still "emerging" from a decade of crippling monetary deflation -- has lost almost 13% since May 10, putting it down more than 8% for the year. Japan's attempt to recover from deflation has been aided by a too-easy Fed, which has caused the Bank of Japan to inject yen liquidity to keep the currency competitive versus a falling dollar. The Fed's new inflation-fighting resolve promises to strengthen the dollar which, in combination with the BOJ's having signaled an end to its deflation-fighting "quantitative easing" program, puts Japan's reflation at significant risk.

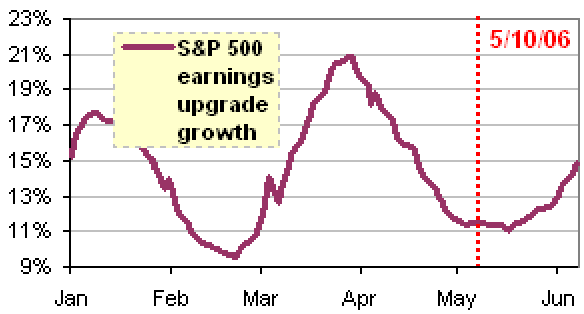
THE WALL OF WORRY BACK IN PLACE All of the effects we've described so far are entirely reasonable in light of the clarification of the Fed's inflation-fighting focus following the May 10 FOMC meeting. And so, painful as they may be to some investors, they are all to the good -- because a central bank focused on the primary mission of inflation-fighting, and admitting there is still work to be done, is a good thing. Yet the conventional wisdom has taken this as yet another opportunity to create a narrative about a significant impending economic slowdown. Such narratives have recurred over and over throughout this expansion, providing a reliable wall of worry for a bull market in equities to climb. We see this latest edition of the same tired narrative as no more likely to turn out to be true -- although, of course, it offers its own unique and shameless variations on a theme. Now the drop in commodity prices is being cited as one of the proofs of an impending slowdown -- though on the way up, their rise was credited solely to "geopolitical tensions" (which were also offered as proof of an impending slowdown).

The essence of the narrative is always that high interest rates will kill the expansion -- in one variation, by being downright restrictive; or in another variation, by removing the artificial stimulus that caused the expansion in the first place. That was the narrative when interest rates were 1%, when they were 2%, when they were 3%, 4% and now 5%. At all points along the way, one more rate hike was said to be destined to roll the economy over, leaving the Fed no choice but to immediately cut short its tightening regime and begin easing again. Today, even with the Fed explicitly focused on reining in inflation expectations with higher interest rates, the assumption that such action will damage the economy is so strong that fixed income markets are priced for only one more rate hike, following by a brief pause, and then the onset of a new easing regime: "one, done, and ease." Thus 10-year Treasury yields have fallen 14 basis points since May 10, and are now inverted relative to the current fed funds rate.







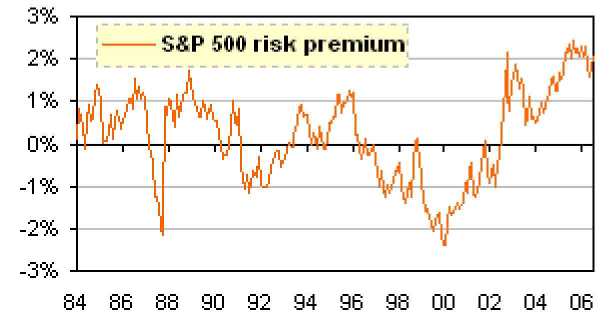


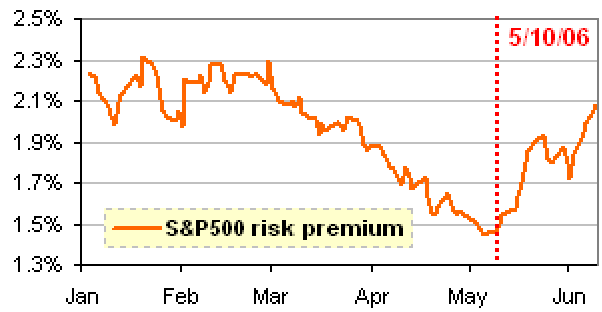
We agree that sufficiently high interest rates could kill the expansion. But several more Fed rate hikes won't make rates dangerously restrictive. Rates at these levels, and a bit higher -- whether measured in real or nominal terms -- are not high by historical norms. And relative to the rates of return available in the economy, they are downright low. Nominal GDP growth is far above the nominal fed funds rate -- farther above it than at almost any time in the last quarter century. This means that money is still more than plentiful enough to fund positive net present value projects. Junk bond spreads tell the same story. While they have widened somewhat since May 10, they are still in the vicinity of all-time lows, meaning that the risk-capacity of the economy -- the wellspring of growth -- is still very vibrant.

At the same time, forecasted corporate earnings continue to surge to all-time highs, now $832 billion. Even after May 10, in a period in which pessimism has been the rule, the annualized rate of month-over-month consensus earnings upgrades for the S&P 500 turned higher -- and now stands just shy of 15%.

Just as we are not worried that another couple of hikes will put rates at restrictive levels, neither are we worried that turning off the spigot of excess liquidity will damage the growth prospects of the economy. That excess liquidity has funded a great deal of speculation over the last couple years. And it surely has crept into some areas of the real economy, perhaps especially housing. But these effects are not stimulants to growth -- they are distortions that detract from growth, and the present economic expansion is made more durable by their removal. The benefit of ultra-low rates was the restoration of sufficient liquidity after several years of increasingly crushing monetary deflation in the late 1990s and early 2000s. That work has long since been completed. At this point the Fed's job is to achieve monetary equilibrium as expeditiously as possible, while inflationary risks can still be reined in with rates that are not restrictively high. If the Fed does a little now, it can avoid doing a lot later.

Perhaps it's ironic, considering the havoc that has been wrought in markets since the FOMC meeting of May 10 -- but the same day also marked a milestone which we believe will play a critical role in a continued economic expansion. On that day the House of Representatives voted to extend the 2003 tax cuts on dividends and capital gains through 2010, and the Senate followed suit the next day, locking in the lowest tax rates on capital in a generation. While the conventional wisdom has credited an easy Fed for the economy's vibrancy over the last three years, we think it's the 2003 tax cuts that really deserve the credit. That's because it's the natural tendency of the economy to grow, unless it is exogenously interfered with. Taxes on capital interfere directly with the risk-capacity of the private economy -- again, the wellspring of growth. When capital taxes are lowered, that interference is reduced, and higher growth rates are a direct consequence.





BOTTOM LINE: Amidst an outpouring of pessimism, we think the conditions are in place for continued robust growth. As statistical evidence of that growth mounts in a series of upside surprises, the pessimism will recede, and we expect that the last month's dip in US stocks will have been another buying opportunity in a bull market. By historical standards -- relative to forward earnings and Treasury yields -- stocks remain strikingly cheap. On May 10, the S&P 500 risk premium had narrowed from all-time highs last October to its lowest point in over a year, but was still quite elevated. Following May 10, as stocks and Treasury yields fell and earnings continued to surge, the risk premium has considerably widened again. If the conventional wisdom is finally right this time, then with this kind of risk premium, stocks don't have very far to fall -- and with an already inverted yield curve, bonds don't have very much to gain. So there's little to be gained by betting with the conventional wisdom. We think the conventional wisdom will be wrong again, and that the facts support a bull case for the economy and for stocks, and a bear case for bonds. The generous equity risk premium affords a strong tailwind for betting with us. TM