TrendMacrolytics

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Inflection Point Deflected

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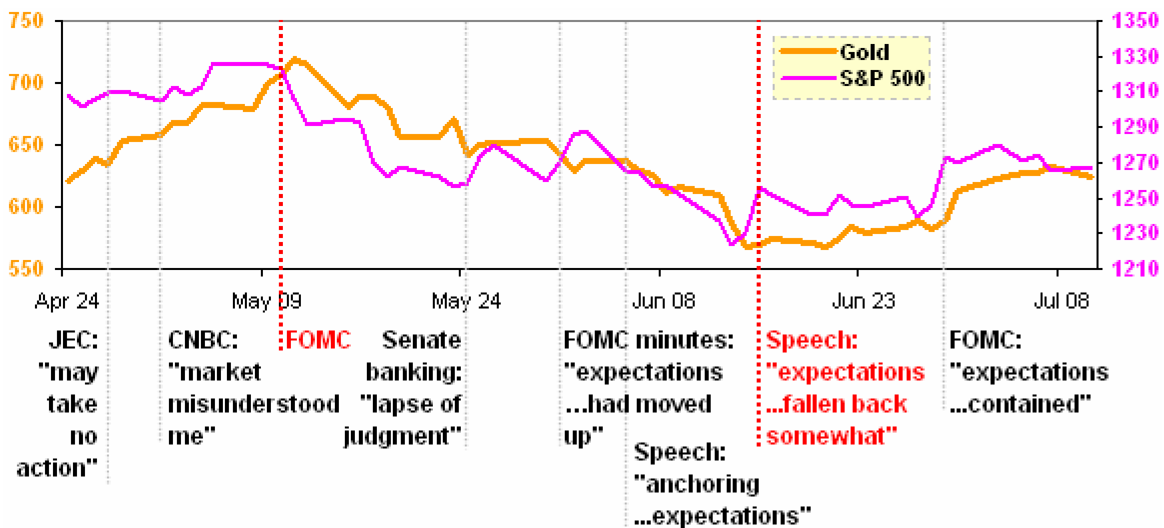
Equities need the Fed to find the courage and credibility to deal with inflation risk.

We're facing a critical test of our thesis that May 10, the date of the second to most recent FOMC meeting, was a critical inflection point -- marking the moment when markets began to come to terms with the end of the inflationary era of excessive Fed ease that began in late 2002 (see "The May 10 Inflection Point" June 12, 2006). We've said several times since May 10 that the ensuing stock market decline was a buying opportunity (see Investment Strategy Dashboard: US Stocks). But we are concerned that we might have been "right for the wrong reasons," as we often say of the Fed. We are looking for a durable move up in equities based on the recognition not only that the Fed will (1) soon be done hiking rates, but that (2) it will have hiked them high enough to quell the inflationary impulses that have resulted from almost four years of excessive ease -- and (3) that the these high rates are not so high as to impede economic growth.

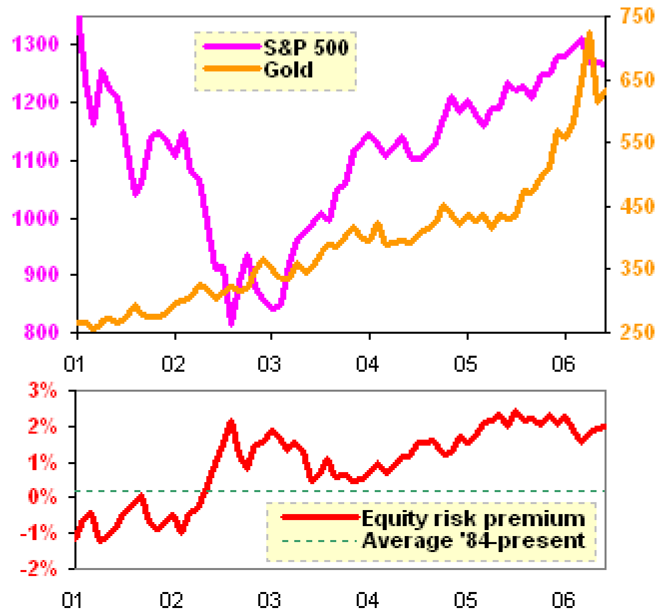
This idyllic scenario is within our grasp, but we're not there yet, and there is mounting doubt that we will get there. It will take hawkish resolve by the Fed to get there, and recognition by investors that such resolve paves the way for a more durable economic expansion. The only price to be paid will be the demise of the inflation-driven "what's working" trades of the past several years -- carry trades, commodities, emerging markets bonds, weak dollar plays, and so on -- the trades that got hurt the worst in the May decline. If our inflection point is really an inflection point, we need to see a divergence -- a change in leadership -- in which the inflation plays continue to falter at the same time as the broader equity market recovers. It's worrisome to us that since the stock market bottom on June 13, as the Fed has pulled back from the hawkish tone it adopted in May, that divergence has not materialized. Stocks overall and the inflation plays have recovered at the same time.

Update to strategic view
US STOCKS: The May decline has been a buying opportunity. But the longevity of the present rally depends on a change of leadership away from inflation plays. Fed vacillations put everything at risk. **INFLATION PLAYS (GOLD, COMMODITIES, US DOLLAR, US RESOURCE STOCKS, US SMALL STOCKS):** If the Fed can regain its inflation-fighting footing, then we expect another leg down in all inflation-sensitive sectors (and another leg higher for the dollar). For the moment, a vacillating Fed has given these sectors a new lease on life (and has dealt a blow to the recovery of the dollar).
[see Investment Strategy Dashboard]

The chart on the following page shows the lockstep relationship between the stock market and gold -- as a proxy for inflation plays as a class -- over the last several months, correlated to pronouncements from the Fed bearing on inflation expectations. Both gold and stocks rose after Ben Bernanke's dovish April testimony to the Joint Economics Committee. They topped out together shortly following the May 10 FOMC meeting that marked the Fed's turn toward more aggressive management of inflation expectations. And they have both rallied together since Bernanke's conciliatory June 15 speech noting that inflation expectations had "fallen back somewhat."



This correspondence between stock prices and inflation expectations is anomalous and unsustainable. Statistically, over history gold and equities are almost entirely uncorrelated. But from first principles, we know that while stocks are nominal instruments, rising inflation (as reflected in a rising gold price) is nevertheless bad for equities in real after-tax terms. So, simplistically, over the broad sweep of time we would expect stocks and gold to move in opposite directions. Indeed, since the top in gold in January 1980, at the climax of the 1970s hyperinflation, a generally falling gold price set the backdrop for the greatest bull market in stocks in history, with the S&P 500's compound annual total return at 13.1% from then to now.

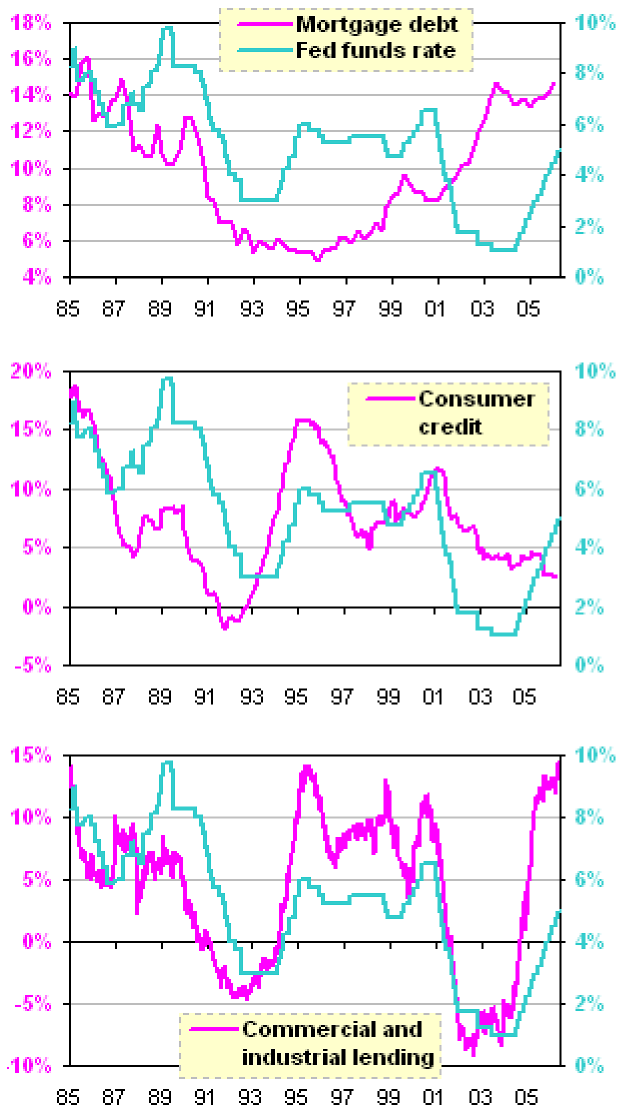


So the current bull market, born at the bottom in October 2002, has been quite unusual in that rising stock prices have been in synch with rising gold prices all along. As the chart at left demonstrates, since October 2002, when gold has rallied so have stocks; when gold has paused, so have stocks. Initially this synchronicity was justified by the fact that the rising gold price was evidence of the end of the Fed's destructive monetary deflation that had begun in 1997, during which the gold price fell from above $400 to about $250. Stocks bottomed in October 2002, as the gold price recovered back up to its long-term average -- in fact, the 10-year moving average price of gold turned up that very month after falling for five years -- all indicating that the deflation was over, and that monetary equilibrium was restored. With that as a platform, and followed six months later by the 2003 tax cuts on dividends and capital gains, a robust expansion was set in motion -- and a bull market in stocks along with it.

But since then, the monetary platform underlying this expansion has become increasingly unstable. The bounceback from deflation, the incentive effects of the 2003 tax cuts, and a global productivity surge has masked the reality that the Fed, immediately upon redressing its prior *de*flationary error, embarked upon an *in*flationary error. Just when monetary equilibrium had

finally been restored in late 2002, the Fed belatedly began worrying about deflation -- after it no longer existed. Ben Bernanke's famous November 2002 speech, ["Deflation: Making Sure 'It' Doesn't Happen Here,"]() launched an era of excessive Fed ease by talking about the "printing press" and a "helicopter drop" of money. There is very little historical precedent for today's post-deflation environment, so it's hard to forecast exactly how bad will be the consequences of the Fed's inflationary error. Surely some of it will be absorbed by lingering deflationary impulses left over from the Fed's previous error (see ["Today and 1987: Ominous Parallels? Part 2"]() June 2, 2006). But there's no escaping the fact that an inflationary error is underway, and a price will be paid for it.

As the lower panel of the previous chart shows, equities have been cognizant of the risks arising from this error from the beginning. The equity risk premium -- which compares the forward earnings yield of the S&P 500 to the income yield of long Treasuries -- spiked to what was then an all-time high at the panic bottom of 2002, but since then has remained at very elevated levels. In fact, this is now the longest time ever that the equity risk premium has remained above its long-term average. With the equity risk premium so consistently elevated in the face of inflation risk, what has been responsible for the gains in stocks since the 2002 bottom? Simple: it's been earnings, and nothing but earnings. Since the day of the October 9, 2002 bottom, consensus forward earnings are up 65%. The market cap of the S&P 500 is up 63%. With earnings valued for almost four years the same way they were at a panic bottom, stocks seem to have impounded a "loss reserve" against the costs of eventually unwinding the inflationary error that began at the same time that the bull market did.



If the inflationary error can now be contained without inducing a recession, stocks are in a position to release that "loss reserve." Based on historical norms, if it happened all at once, and if all other factors were held equal, this suggests that the S&P 500 should be about 33% higher than it is today. So that leaves two threshold questions. First, will a fed funds rate in the neighborhood of 5.5% -- where we and the consensus pretty much agree the Fed will be shortly -- be enough to quell the inflationary impulses building up over the last almost four years? And second, will such interest rates be so high as to end the current expansion?

Taking the second question first, the conventional wisdom's answer would seem to be "yes." But then again, that was the conventional wisdom's answer to the same question when it was asked about a 2% funds rate, a 3% funds rate, a 4% funds rate, and so on. Yet today's funds rate -- and even a bit higher -- was the norm during the booming second half of the 1990s. The conventional wisdom rebuts that by arguing, in essence, that the entire

present expansion has been little more than a debt-financed fake -- a carry trade or an inflation play -- subsidized by the Fed. That sure doesn't show up in the credit statistics, as the charts at left demonstrate. Mortgage debt has been expanding since 1995, pretty much irrespective of the funds rate. Consumer credit growth has been falling over the same period, just as oblivious to fluctuations in the funds rate. Commercial and industrial lending growth has pretty much tracked the funds rate lately, as it always does -- if anything, it's been leading the funds rate on the way up over the last two years. So whether or not this expansion has been debt-financed, it doesn't seem to have much to do with the funds rate.

Now to our first question -- will a funds rate of 5.5% or thereabouts be enough to reverse the Fed's inflationary error? If not, then we would face the risk of rates eventually having to move high enough to trigger a recession. We still think 5.5% is probably the top, but it's by no means a sure thing -- or even as probable as we thought it was just a month ago. Then we were impressed by what seemed to be the definitively hawkish position reflected in the May 31 minutes of the May 10 FOMC meeting, in which it was confessed that inflation expectations were becoming elevated, and Ben Bernanke's June 5 speech, in which he acknowledged the primary importance of anchoring those expectations (see "Bernanke Arrives" June 6, 2006). But more recently we've been deeply troubled by the glibness with which the FOMC was able to congratulate itself, on June 29, that "inflation expectations are contained" (see "Fed Roulette" June 30, 2006). From Bernanke's April 27 Joint Economic Committee speech to the present -- that is, within a period spanning less than three months -- we've gone from being told (definitively in every case) that inflation can take a back seat to growth risks, that inflation is Job One, that inflation expectations are contained, that inflation expectations are coming unglued, and again that inflation expectations are contained. Is what we have here is a failure to communicate, or is Ben Bernanke the Hamlet of central bankers? Either way, these vacillations erode confidence and leads directly to aversion, at the margin, to hold dollars -- which is itself inflationary. A 5.5% funds rate administered by a decisive and credible Fed should be enough. A 6% funds rate administered by a vacillating and uncredible Fed may well not be.

BOTTOM LINE: The present expansion and bull market in equities was born in 2002 when the Fed corrected its *de*flationary error -- but it's been imperiled ever since by the Fed's *in*flationary error. The risk to the expansion is not interest rates at current levels or a little higher -- the risk is a vacillating and uncredible Fed that lets risk aversion and inflation expectations get out of hand. Equities have priced for that contingency ever since the October 2002 bottom. If, as we still hope, the Fed can get it right here -- by expeditiously moving to a 5.5% funds rate and making it perfectly clear that deterioration in inflation expectations will not be tolerated -- then equities will find themselves in a sweet spot. A 5.5% funds rate won't be enough to put a dent in earnings growth. And at the same time, the resolution of the inflation error will allow equities to give up the abnormally high risk premium of the last almost four years. TM