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

MACROCOSM

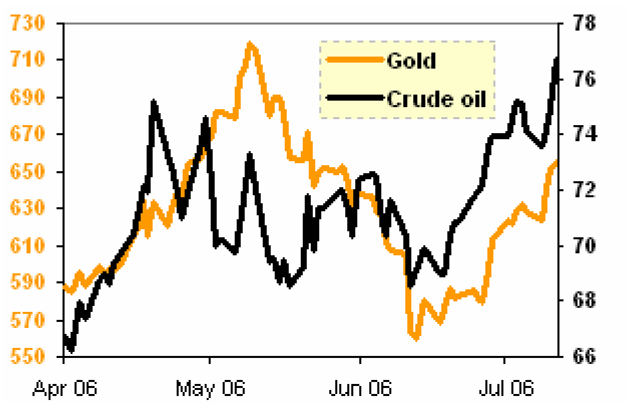
The Middle East, Oil, Gold and the Fed

Friday, July 14, 2006

David Gitlitz

Geopolitical tensions are only adding insult to injury. The real risk is in monetary policy.

The outbreak of renewed Middle East violence and the consequent boosting of the risk premium in crude oil prices is extracting a heavy toll on US equity markets. Two common assumptions among market analysts and the financial media is that the oil surge has been entirely attributable to the intensification of geopolitical risk, and that the gold price has risen back to above $660 "in sympathy" with crude. To be sure, geopolitical risks explain a good part of the current spike in gold and oil prices, which offers hope that a diminution of those risks will be met with some rollback. However, the coincidence of recent oil and gold price turns also suggests that oil has been moving in tandem with gold for reasons having nothing to do with geopolitical events, and could therefore maintain at least a share of the recent bump higher even with the ebbing of geopolitical risk. The track of oil and gold price movements the past few months indicates that the monetary factors that are the primary determinant of the gold price have also had a significant effect on the crude market. Rather than gold prices being a more or less passive response to rising oil prices, it appears that black gold in important ways is carrying the same message as the yellow metal: Fed policy remains accommodative, and is continuing to transmit inflationary influences on dollar purchasing power.



A quick review of recent history will show that the current upmove in both gold and oil had its roots in events that are entirely separate from today's geopolitical risks. The NYMEX light crude price hit its recent low below $69 per barrel in mid-June at the same time the gold price was falling back to around $560 on the more hawkish noises then emanating from Fed chair Ben Bernanke and his colleagues. This came following the run-up in gold in the

Update to strategic view

US MACRO: Surging gold and energy prices have been aggravated by Middle East risks, but more fundamentally they reflect risks of an inflationary error by the Fed. If Ben Bernanke doesn't move to head off that error, the inevitability of far higher interest rates will cause us to downward revise our positive outlook on growth.

US STOCKS: Geopolitical risks have pressured stocks this week, but the real risk is an inflationary error by the Fed. Middle East tensions will pass -- but unless Bernanke moves to head off that error, we are poised to abandon our bullish view on equities.

OIL: Geopolitical risks are only frosting on the cake for oil -- inflation expectations are the deeper driver of the crude price. As Middle East tensions abate, we expect crude to come off today's peaks. But ongoing Fed ease is building in the risk of a higher permanent floor for oil.

US BONDS: Bond pricing is simply missing clear and present inflation risk, as it has in the past. Whether the Fed is easy or tight here, bonds are a bad bet.

[see Investment Strategy Dashboard]

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

10 sessions after Bernanke's ill-advised dovish comments to the Joint Economic Committee on April 27, suggesting the Fed could pause even if it continued to see risks of higher inflation. The oil price response then was less pronounced than that of gold, which jumped from just above $630 to around $720. But though crude rose just 3.5% on net over this period to $73, it then followed the track of gold lower after the more hawkish than expected May 10 FOMC statement and the subsequent comments from policymakers seeming to reaffirm it. The more recent inflection point, in mid-June, came when Bernanke reverted to his dovish ways, musing that inflation expectations "have fallen back somewhat in the past month." Two weeks later, that dovish bent was apparently reaffirmed with the FOMC statement opening the door to a pause -- or halt -- in the present rate hiking cycle, resorting to the dubious rationale that a moderation in growth "should help to limit inflation pressures." In the past month, gold is up more than 18%, oil 15%.

One indicator seeming to run counter to the message of inflation-sensitive commodities (the CRB spot index, which does not include gold and oil, is near record highs, up about 4% in the past month), has been the bond market, where the yield curve continues to show a slight inversion and the 10-year yield has fallen back by about 18 basis points from 5.25 since just before the June 29 FOMC meeting. Apart from the safe haven bid that has come into play the past few days, the bond rally has primarily been explained by the FOMC's dovish turn last month, which actually reinvigorated hopes for policy easing within the foreseeable future. The Eurodollar futures curve now shows odds of 66% favoring a rate cut between this September and September 2007. Those chances were put at only about 25% prior to the meeting. Contrary to the classical view that the bond market is an efficient mechanism for pricing inflation expectations -- which has often been refuted by real-world events -- the yield curve is currently discounting expectations that a seemingly inflation-complacent Fed will inevitably compound the error. Until fairly recently, we would have strongly refuted that proposition. One thing for sure, though: if the bond market's current call on the course of Fed policy is proven correct, the inevitable inflationary consequences will assure that current yields and prices will come to be seen as representing an historically bad bet.

BOTTOM LINE: Our bullish take that the stock market downturn represents a buying opportunity is facing a difficult test. Our supposition has been that the market's fears of Fed overshoot would prove unfounded because the Fed would reach policy equilibrium at a funds rate target that would not prove to be growth-inhibiting. Key to this outlook was our belief that the Fed would remain vigilant and subdue inflationary risks to preclude a destructive inflation breakout. Our confidence in that outcome, however, has been shaken by the prospect of the Fed moving to prematurely conclude this policy cycle. If it does, the inflationary consequences would then unavoidably be met by an aggressive Fed response, putting the sustainability of the current expansion at extreme risk. Bernanke's congressional testimony next week will be pivotal in shaping the outlook in this climate of intensifying risk. TM