TrendMacrolytics

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

MACROCOSM

Judgment Day

Thursday, August 3, 2006

Donald Luskin

Tuesday's FOMC meeting will be pivotal for markets and the economy.

If the fails to hike rates at next Tuesday's FOMC meeting, it will make a significant policy error that will have very negative consequences for the economy and both stock and bond markets. This view stands in opposition to today's conventional wisdom, as expressed by widely followed strategists and economists, that a Fed pause will be the first step down a road leading to lower interest rates, relief for a faltering economy, and an expansion of equity earnings multiples. The conventional wisdom is based on uncritically accepting the Fed's view of the state of the world: specifically, an economy already slowing as the result of past rate hikes, which will lead directly to a slowing of inflation.

Every element of the Fed's view is wrong. The economy is not slowing -- it is still strong. Even if it were slowing (which it is not), that would not lead to a slowdown in inflation, because inflation is not caused by economic growth in the first place. The consequences of pausing the present rate-hiking cycle based upon this mistaken view will be that the Fed would soon be obliged to come back with draconian rate hikes, as evidence pours in over the coming months demonstrating that neither the economy nor inflation is slowing. Even if, due to some unexpected shock, the economy were to slow significantly in the back half of the year, inflation would continue to mount -- because growth or no growth, the Fed would have failed to sufficiently sop up today's excess of dollar liquidity.

So no matter what, the consequence of not hiking rates a little bit now is to inevitably hike them to economy-killing levels later. The inevitable consequence would be recession -- and neither stocks nor bonds would come out alive. Stocks today are already priced to anticipate much higher interest rates, but not a combination of higher rates *and* a recessionary earnings decline. Long-term bonds, on the other hand, with yields already inverted to short rates, are priced for recession -- but they haven't the slightest margin of error for higher interest rates. We still cling to hopes that the Fed will -- whether for right reasons or wrong -- hike rates again on August 8, and forestall this grim future. But make no mistake about it: this is judgment day. For three-plus years we have been bulls on the economy and on stocks -- correctly standing against the bearish conventional wisdom through thick and thin. We still cling to hopes that the Fed will do the right thing next week, whether for the right reasons or the wrong reasons. But if they don't -- if, say, a weak jobs number tomorrow is enough to tip a data-dependent Fed into a dovish blunder -- we are fully prepared to call the top.

Update to strategic view
FED FUNDS: We marginally expect the Fed to hike to 5.5% at the August 8 FOMC meeting, recognizing that tomorrow's jobs report is an unpredictable risk factor. **US STOCKS:** If stocks are rallying in expectation of a Fed pause, then if the Fed does pause it will be a selling opportunity. If the Fed does not pause, and stocks fall back, it will be a buying opportunity. **US BONDS:** Bonds are priced for recession, lower rates, and no inflation. They are wrong on all counts, and thus are highly vulnerable here.
[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

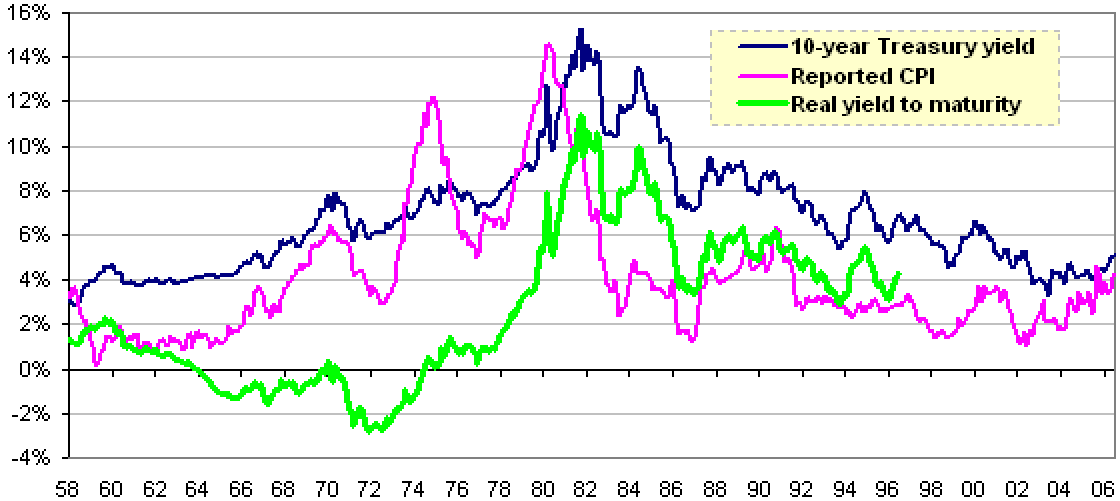
THE ECONOMY IS NOT SLOWING Last Friday's 2nd quarter GDP report does not at all convince us that the economy is slowing in any significant way (see "Data Dependent" July 27, 2006). The necessary preconditions of future growth that have driven our bullish outlook on the economy for the last three-plus years -- credit spreads, lending activity, and capital spending, all of which point to the risk-taking and capital formation that produce growth -- are still very much intact. We are not especially concerned by the apparent sequential quarterly drop-off in non-residential fixed investment in equipment reported on Friday. More than the entire $2.6 billion drop is accounted for by the $9 billion drop in transportation equipment. And we are heartened by the 2.5% increase in personal consumption expenditures -- admittedly down from the first quarter, but still robust considering that, in the second quarter, spending was not propped up by an increase in housing wealth. Since Friday's report, other economic data confirms that the third quarter is off to a strong start. It is nearly inevitable that the Fed's current forecast of 2% to 2.5% real growth in the back half of 2006 is going to be a gross underestimate.

INFLATION IS NOT SLOWING Friday's GDP report provided more evidence that the inflationary consequences of the Fed having stayed too accommodative for too long are becoming embedded in the economy (again, see "Data Dependent" July 27, 2006). Every single price index in the report was higher on a sequential quarterly basis, most notably the core PCE deflator rising from 2.1% in the first quarter to 2.9% in the second quarter. This lagging statistical evidence of inflation confirms what the forward-looking market-price indicators of inflation -- gold, commodities, energy, the dollar -- have been signaling for three years. While off their most elevated levels of early May, those indicators still point to considerable future inflation. Today's gold price, for example, points to core Consumer Price Index inflation from 4.7% to 7.8% (based on our historical regression model, with an r-squared of 0.67). Reliance on market-price indicators allowed us to anticipate the upturn in inflation that occurred in December 2003 with core CPI at 1.09% when the conventional wisdom -- and the Fed -- were worried about nothing but deflation (see "Desperately Seeking Inflation?" October 29, 2003). Unless the Fed hikes rates sufficiently to move the indicators significantly lower -- gold to about $475, for example -- there is virtually no doubt that inflationary impulses will continue to feed into the economy. Even if the Fed acts properly and promptly, reported statistical inflation is destined to rise based on nothing but the Fed's prior sins, due to the lags involved. But prompt and decisive action can nevertheless considerably limit the damage.

A SLOWING ECONOMY WON'T SLOW INFLATION The Fed created the present inflation by staying too easy for too long. The only thing that can contain that inflation is for the Fed to set rates at least at equilibrium levels, which have not been attained yet. A slowing economy (and again, the economy is *not* slowing) will not do the Fed's work for it. In Milton Friedman's famous phrase, inflation is everywhere and always a monetary phenomenon. If monetary conditions are loose, even during a period of slow growth, inflation will rise -- just as we saw in the 1970s. If monetary conditions are tight, even during a period of rapid growth, inflation will recede -- just as we saw in the 1980s and 1990s.

When pressed, Ben Bernanke seems to admit as much. Two weeks ago in testimony before the House Financial Services Committee, he told Congressman Ron Paul, "...growth doesn't cause inflation. What causes inflation is monetary conditions..." Unfortunately, Bernanke didn't leave it at that. He continued, saying that those monetary conditions "stimulate spending, which grows more quickly than the underlying capacity of the economy to produce." Thus, today, the Fed seems to believe that instead of addressing monetary conditions directly, it can rely on a slowing economy to diminish spending. But that belief fatally omits the fact that, in a slowing economy, both spending *and* production are reduced -- demand is extinguished, but so is supply. The only way to directly deal with inflation is to address its root cause -- monetary conditions characterized by excess liquidity that cheapens the unit of account in relation to all goods and services for which it exchanges.

BONDS AREN'T CALLING INFLATION RIGHT Some observers who agree with our use of market-price indicators to predict future inflation are drawing comfort from the bond market. The yields of long term bonds ought to embody an inflation risk premium, and given today's inverted yield curve it would seem that bonds are anticipating a future with virtually no inflation at all. This is false comfort. The historical record is unambiguous that the bond market is a miserable predictor of future inflation.



The chart above shows the history of CPI inflation and the nominal and *ex post* real yields of the 10-year Treasury bond (with the real yield defined as the nominal yield minus the compound CPI inflation rate that actually obtained over the ten years following each observation). If bonds were consistently pricing for inflation correctly, we would expect to see a roughly constant *ex post* real yield over time. But in fact, it has been all over the map -- and always wrong. Even as reported CPI inflation exploded following 1964, the 10-year's nominal yield remained too low to generate a meaningful, or even positive, *ex post* real yield for almost 15 years. Bond yields rose to compensate investors for inflation only after inflation peaked, and yields stayed high throughout the 1980s and most of the 1990s, even as inflation continued to fall. Thus bonds got it wrong both ways -- blind to inflation on the way up, and blind to disinflation on the way down. Past performance is no guarantee of future returns, but we would think investors would be quite foolish to put much reliance on this market -- as deep and liquid as it may be -- as a useful guide to future inflation.

BONDS AREN'T CALLING THE ECONOMY RIGHT, EITHER Today's inverted yield curve is priced for an imminent recession, suggesting that the Fed has already raised rates to prohibitive levels. The Eurodollar futures curve is priced for more than a 25 bps Fed rate cut by September 2007, and the brand-name bond gurus who have gotten the Fed and the economy wrong for the last three-plus years are telling anyone who will listen that the rates cuts will come sooner than that, and be deeper than that. Bonds are wrong, and so are the gurus. There is no evidence that the economy is markedly cooling, and as we outlined above, much to suggest that it will continue to be strong. What could cause a recession is prohibitive interest rates imposed by the Fed later this year or early next year. Thus the only recession the bond market is likely to get is one associated with higher interest rates, not lower interest rates. With a funds rate of, say, 6.5%, the yield curve would have to become inverted by 1.5% *just for bond prices to break even* from today's levels.

STOCKS ARE PRICED FOR A BIG FED MISTAKE Bonds have priced themselves onto a tall, narrow pedestal from which the slightest Fed error means a big fall. Stocks, on the other hand, are priced with a deep cushion that should go a long way to absorbing a Fed error. Consider these statistics. On the day of the bear market bottom on October 9, 2002, the forward price/earnings ratio for the S&P 500 was 14.4. Since then, forward earnings have grown by 66.8% -- but the S&P 500's market cap has only grown by 64.7%. Thus today's forward p/e ratio of 13.9, lower than that of October 9, 2002. Stocks today are even more unloved -- more of a pariah asset class -- than they were on the day of a panic bottom culminating the second longest and second most severe bear market in history. The whole bull market from there has been purely earnings-driven. Sentiment has not improved -- it has slightly worsened. Perhaps the reason is that the October 2002 bottom was associated with the Fed's belated concern with monetary deflation. It was the month after that when Ben Bernanke gave his notorious speech about deflation, bragging about the Fed's ability to fight it with the "printing press" and "helicopter drops of money." Considering that the Fed's deflation awareness came after the problem was already largely fixed -- as evidenced by gold having then already rallied from its deflationary lows around $250 back to its long-term average price of about $325 -- much of the Fed's subsequent accommodation was unnecessary -- and, therefore, inflationary. Stock prices, by refusing to do anything but track earnings higher, have built in a "loss reserve" against judgment day -- the day when the Fed will have to jack up interest rates to prohibitive levels to atone for its inflationary sins. Based on historical norms, today's multiples are associated with long-term interest rates about 200 basis points higher than today's rates.

JUDGMENT DAY We have been saying for a very long time that the Fed has been too easy for too long. What makes next week's FOMC meeting so especially pivotal? For one thing, until now, we have been confident that the Fed would continue to hike rates at its "measured" pace -- too slow for our tastes, and motivated by the wrong reasons, but at least always moving in the right direction. Today fed funds futures are priced for only a 43% probability that the Fed will do the right thing and raise rates to 5.5%. Our guess is only slightly more optimistic -- say, 55% or 60%. Thus we are at risk of a Fed already behind the curve putting itself, for the first time, even further behind.

Second, this FOMC meeting follows a recent episode in which Ben Bernanke was forced to react to evidence of sharply rising inflation expectations. With gold at $725, the TIPS spread at 2.7%, and the dollar falling in early May, Bernanke had no choice but to declare that inflation expectations were coming unglued, and reassure the markets that re-anchoring those expectations was his Number One priority (see "Bernanke Arrives" June 6, 2006). Having drawn that anti-inflation line in the sand, those measures of inflation expectations fell back sharply. But by the end of June, Bernanke had declared "mission accomplished" and reverted to worrying about a slowing economy, and relying on a slowdown to contain inflation (see "Fed Roulette" June 30, 2006). Like a misbehaving child whose father threatens to spank but then doesn't follow through, all the measures of inflation expectations have started to misbehave again -- they've crept back up more than halfway toward the levels that got Bernanke concerned in the first place. A failure to hike rates on August 8, accompanied by more false assurances about a weakening economy, could cause those measures of inflation expectations to challenge their old highs -- and Bernanke's line in the sand. If they do, Bernanke will be put to the test. Will he defend his line in the sand? Will he have the credibility to succeed? If more threats to spank fail, then economic slowdown or no economic slowdown, and probably sooner rather than later, it will be clobbering time.

BOTTOM LINE: The grudging rally in stocks of the last several weeks may well be discounting the Fed's pausing on August 8, as it has been accompanied by a rally in indicators of inflation expectations such as gold, commodities and energy, and a decline in the dollar. If that is true, then if the Fed does pause, it's not clear how much residual upside there would be for stocks. But, on the other hand, if that is true then it is based on an error in the first place -- stocks should really want the Fed to hike rates on August 8, in order to reduce the risk of its having to hike rates to prohibitive levels later. Any rally based on such an error is probably a selling opportunity. But that's not the way the conventional wisdom appears to see it. If the Fed does hike rates on August 8, we would probably see a downdraft in a disappointed stock market. And in our view, that would be a buying opportunity. Over the coming months, as evidence that the economy is not slowing pours in, the earnings-driven stock market should track higher. And if -- dare we hope -- that somehow the Fed gets it really right here, and we see gold and other inflation indicators start to markedly fall back, then that "all clear" signal could open the possibility for long-delayed multiple expansion.

Bonds, on the other hand, are hopeless. They are counting on both a recession and lower interest rates -- they will not get either any time soon, and certainly not both at the same time. And they are completely ignoring inflation as a factor. TM