TrendMacrolytics

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MARKET CALLS

Bernanke's Quagmire

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The Fed will cause a real recession by trying to prevent an illusory one.

It seems inevitable now that the Fed will pause the present rate-hiking regime at tomorrow's FOMC meeting, thanks to a couple of seemingly weak macroeconomic datapoints (see "March to Folly" August 4, 2006). So why isn't the stock market celebrating? Wasn't a Fed pause supposed to be the starter's pistol for the next leg up? It would have been and could have been, if it had come at a level of interest rates sufficient to halt and reverse the inflation pressures the Fed has created by being too accommodative for most of the last four years. If the Fed had moved to those higher rates without pausing on the way, they needn't have been much higher than today's, and the pause could have been a permanent halt. Those rates could have been high enough to remove excessive accommodation and deal with inflation pressures, but not so high as to wreck the economic expansion. But by pausing tomorrow our view is that the Fed is forsaking the opportunity to engineer that ideal outcome (see "Judgment Day" August 3, 2006). By pausing in the name of a slowdown that isn't happening, the Fed adds more accommodation and more inflation pressures, which will necessitate a higher expansion-killing level of rates in the future.

This represents a major change in our long-term outlook. We have been bulls on the economy and the stock market for three-plus years, and correct to be so. We have been hawks on inflation and on the Fed throughout this entire hiking cycle, and correct to be so.

- We now expect the Fed to pause tomorrow, but we believe this sets up the necessity for the Fed to resume hiking rates later this year, probably taking the funds rate above 6%.

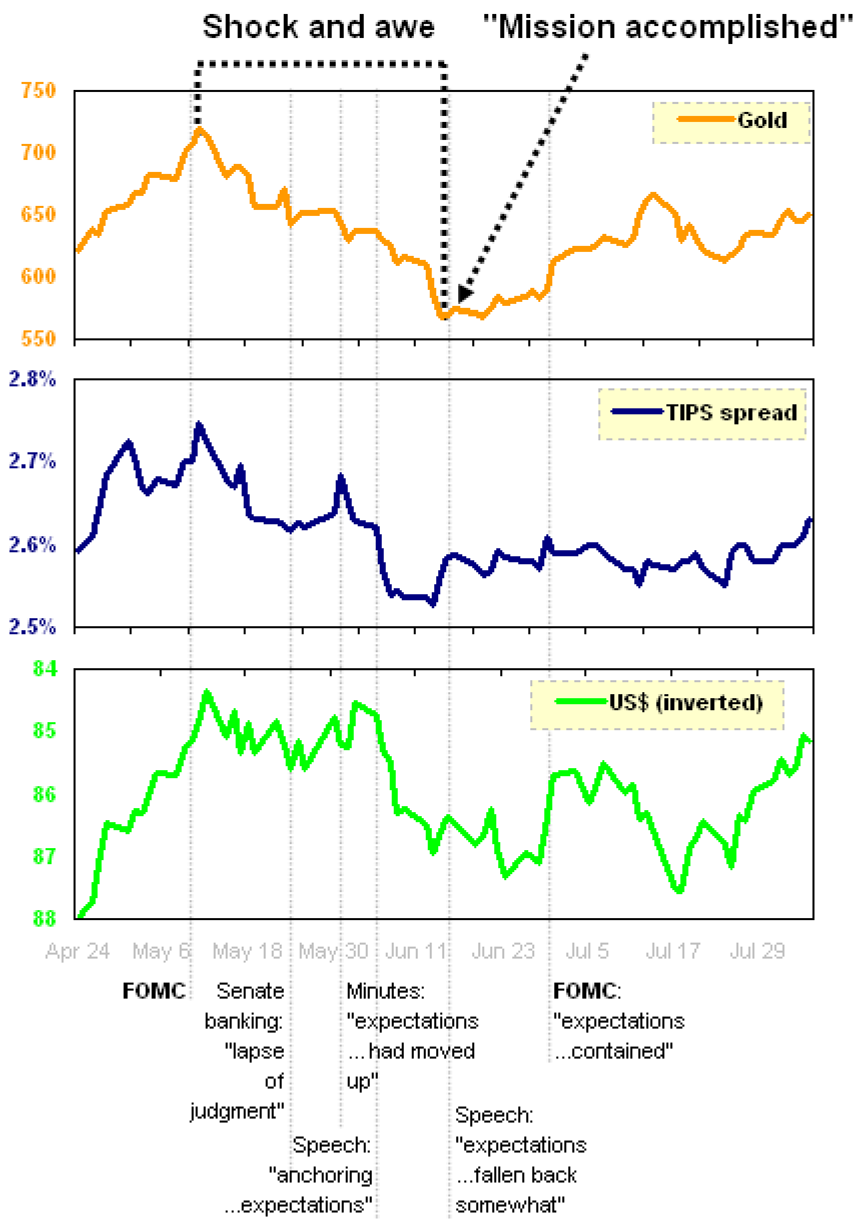
- While we maintain that the economy is not slowing in any important way now (see "Data Dependent" July 27, 2006) -- a Fed pause tomorrow virtually guarantees a recession just over the horizon in response to a 6%-plus funds rate.

- Stocks are already undervalued, which, in combination with a likely near term continuation of economic strength, could support prices. But stocks are by no means

Update to strategic view
US MACRO: A pause in the Fed's rate-hiking regime in the name of a slowdown that isn't happening is setting up the Fed for expansion-killing rate hikes in the future. **US STOCKS:** Near-term evidence of continued economic strength, and deep undervaluation, mean that stocks could find support here. But with a Fed committed to a course that will lead to an expansion-killing tightening, rallies are selling opportunities. **INFLATION PLAYS (GOLD, COMMODITIES, RESOURCE STOCKS, OIL, DOLLAR):** The Fed's premature pause sets the stage for rallies by inflation-sensitive sectors to challenge their May highs (and a decline in the dollar to challenge its May low). But this may be short-lived, as it will probably draw a strong response from the Fed.
[see Investment Strategy Dashboard]

fully protected from both a full-on recession and significantly higher interest rates, so we would see any near term strength as a selling opportunity.

- We are not changing our view on inflation. Excess accommodation already in the pipeline will inevitably result in higher reported inflation. That, combined with continuing accommodation, will cause inflation expectations to shift higher -- which will be the catalyst for renewed rate hikes.



Inflation expectations will be the most important factor going forward. While the Fed's typical talk of inflation usually centers on macroeconomic variables in the neo-Keynesian, Philips Curve, output gap tradition, inflation expectations have the power to trump all other considerations. Expectations are where the rubber meets the road in the actualization of inflation -- they are what motivate economic actors to set prices higher, one at a time, throughout the economy. And inflation expectations are the report card on the Fed's credibility -- and the Fed is an institution that treasures its credibility, especially now with a new chairman on board. In early May the Fed recognized a crisis in inflation expectations -- gold had risen to $725, the 10-year TIPS spread had widened to 2.72%, and the trade-weighted US dollar had fallen almost 6% year-to-date. The crisis was turned back with a month of "shock and awe" statements from Ben Bernanke affirming the importance of keeping inflation expectations contained (see "Bernanke Arrives" June 6, 2006). But ever since a June 15 speech in which Bernanke declared "mission accomplished" by noting that inflation expectations had "fallen back somewhat in the past month," those expectations have been resurgent -- they've all rebounded at least halfway to their extreme levels of early May. What worries us is -- what happens when they rebound all the way?

Bernanke drew a line in the sand at gold $725, TIPS 2.72%, and so on. Now that the Fed seems committed to betting on a slowing economy (that's not slowing) to reduce inflation pressures (which, even if the economy were slowing, it would have no power to do), continued excess accommodation will continue to build inflation pressures. Bernanke's line in the sand seems sure to be challenged -- perhaps even before the September 20 FOMC meeting. The US dollar is already only less than 1% above its lows of early May. What will Bernanke do when it breaks through? When gold is at $750? When the TIPS spread is at 2.75%? The credibility-maximizing course for the Fed is not clear under such circumstances. Having declared "mission accomplished" too soon, he will be facing an insurgency -- and a quagmire. Will Bernanke feel he has to stick to his story about a slowing economy? Perhaps he won't even have that option, if we are right that the economy isn't slowing. Or will he feel he has to get tough, slowdown or no slowdown, and defend his line in the sand? If the latter, it's not clear that mere words can defend that line the same way they did in May, considering that those words were not backed up by subsequent action. If that's the case, we could see the indicators of inflation expectations break out to significant new highs. At some point then, and probably sooner rather than later, the Fed will be forced back into the rate-hiking business. And we won't be talking about "measured" hikes at that point, you can be sure.

BOTTOM LINE: If we are right that the economy isn't significantly slowing, evidence of unexpected strength in the near term may bolster a stock market that is undervalued to begin with. A rally would be a selling opportunity, as the Fed now seems bound to a course that is likely to lead to expansion-killing rate-hikes, probably starting later this year. The Fed's dovish error is likely to lead to a resurgence of inflation expectations, which should mean another run for inflation-sensitive sectors such as commodities, materials and energy. But that resurgence is likely to be what triggers the next round of rate hikes -- so plays in those sectors should be made with an eye to the exits. TM