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

MACROCOSM

If Only It Were This Easy

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Donald Luskin

We're delighted to see stocks up and gold down -- but don't break out the champagne just yet.

No sooner did we shift our long-term strategic view to negative last week than markets began to act quite positive. Anticipating that the Fed would prematurely pause its rate-hiking cycle at last week's FOMC meeting, we argued that this blunder would set an inexorable course for the economy toward higher inflation, and for Fed toward expansion-killing rate hikes (see "Bernanke's Quagmire" August 7, 2006). But relative to where they stood a week and a half ago before the FOMC meeting, growth-sensitive indicators have moved up -- for example, the S&P 500 has rallied 1.7%, and the NASDAQ 100 has rallied 5.3%. At the same time, inflation-sensitive indicators have moved down -- for example, gold is off 4.9% and the TIPS breakeven spread has narrowed by 5 basis points. On the face of it, this would appear to be the best possible reaction to the FOMC's decision -- just the kind of divergence we have said we would ideally like to see (see "Inflection Point Deflected" July 11, 2006).

The stock market's reaction to what we see as the Fed's critical blunder is not a surprise. We've been saying all along that the decline since early May would be a buying opportunity (see Investment Strategy Dashboard: US Stocks). And even as we moved our long-term view on stocks to negative last week, we noted that the economy is still expanding robustly, and said that "evidence of unexpected strength in the near term may bolster a stock market that is undervalued to begin with" (again, see "Bernanke's Quagmire"). While the media has sought to portray some of this week's macroeconomic reports as evidence of economic slowdown, we think the truth is that the data portray an economy that is reaccelerating vigorously (see "Data Delusions for Doves" August 16, 2006). From its present position of undervaluation, all it takes for stocks to keep trudging higher is for continuing economic strength to keep bolstering the forward earnings consensus.

Update to strategic view

US MACRO: The economy is reaccelerating in the third quarter. But combined with a continuing rise in inflation, the Fed is destined to be drawn into expansion-killing rate hikes in the future.
US STOCKS: Short term, continuing strong growth and easing of geopolitical tensions is supporting prices, and stocks can trudge higher so long as forward earnings continue to grow. Longer term, this will prove to be a selling opportunity when the Fed starts hiking rates to draconian levels.
INFLATION PLAYS (US RESOURCE STOCKS, OIL, GOLD, US DOLLAR: Easing geopolitical tensions and a "sell on the news" reaction to last week's dovish FOMC statement have triggered a sell-off in inflation-sensitive sectors. But as the economy reaccelerates, the Fed is falling further behind the curve. We don't expect much further downside.

[see Investment Strategy Dashboard]

More surprising has been the reaction of the inflation-sensitive market-price indicators we follow. We can dismiss the decline in the TIPS breakeven spread to the bond market's having succumbed to the euphoria of this week's putatively weak CPI and PPI reports -- though both were nothing more than data anomalies (again, see "Data Delusions for Doves"). But we expect the gold market to see through such things. With the most inflation-sensitive of all market-price indicators having fallen from $648 before the FOMC meeting to $615 yesterday, we have to begin to ask "what's going on?"

One possible explanation is that we're seeing a classic "sell on the news" phenomenon. Although we were dragged kicking and screaming to finally accept the reality that the FOMC would err last week (see "March to Folly" August 4, 2006), perhaps the gold market saw it coming all along. Or while we found the FOMC's language to be even softer on inflation than we had feared (see "Surprise on the Doveside" August 9, 2006), perhaps the gold market expected the Fed to be softer still, and was relieved that the words "done forever" didn't appear in the statement.

A particularly compelling explanation is that the drop in the gold price -- along with the stock market rally -- has coincided with the deceleration of hostilities in the Middle East (which, of course, has been reflected most clearly in the falling price of crude oil). In July, when hostilities first broke out, we experienced several days of just the opposite effect: gold up, socks down. We wrote then, "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" (see "The Middle East, Oil, Gold and the Fed" July 14, 2006).

All that said, with gold now below where it was when the present Middle East crisis began, the present move lower "bears further watching," as Ben Bernanke might say. If gold continues to fall -- and if the other inflation-sensitive market-price indicators such as other commodities, the TIPS spread, and foreign exchange continue to move correspondingly -- we'd have to revise our pessimistic inflation outlook. And if we did that, we'd possibly have to revise our pessimistic long-term strategic view, because our expectation that the Fed will end up hiking interest rates to expansion-crushing levels partly relies on the premise that mounting inflation will compel the central bank to do so. But the fall would have to be quite significant and sustained. In gold terms, without a sustained price drop below $500, we wouldn't expect inflation to remain mild enough in the long term to avoid triggering the Fed to draconian action. No matter what gold does now, it's too late -- given the inflationary pressures already in the pipeline -- to avoid seeing a 3-handle on core CPI, probably before the year is out. If gold remains at today's levels, we can expect with high confidence a 4-handle or a 5-handle in the longer term. It's sheer fantasy to think that the Fed could stay on hold in such an inflation environment. Thirty-five years ago this week President Nixon imposed wage and price controls to address what was seen then as an inflation crisis -- when non-core CPI was only at 4.4% on a year-over-year basis. It's at 4.2% right now.

BOTTOM LINE: Based on what we know now, we don't expect to see the kind of sustained downward move in the inflation-sensitive indicators that would promise any real relief. We think the economy is reaccelerating into the third and fourth quarters of the year, and that will make a Fed paused at a 5.25% funds rate increasingly accommodative. If anything, we would expect to see inflation-sensitive commodities and foreign exchange move higher. As to stocks, so long as continued expansion supports continued upward revisions in consensus forward earnings, prices can trudge higher. But unless we see a real sea change in the posture of the inflation-sensitive indicators, we continue to expect that the combination of rapid economic growth and rising inflation will eventually draw the Fed back into the rate-hiking business. The longer it takes, the harsher it will be. TM