TrendMacrolytics

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Foreshocks

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Modest positives rule the near term, but inevitable negatives are just over the horizon.

THAT NOBODY CAN DENY Yesterday's sharp negative reaction by the stock market to the reported rise in unit labor costs was a foreshock indicating earthquakes to come. As longstanding inflation hawks, we take a certain grim satisfaction in this particularly bad news for a Fed so stubbornly in denial of inflation risk (see "Denial" September 5, 2006). The implications ought to be undeniable: rising unit labor costs reflect not only inflation itself, but also the embedment of inflation dynamics in the deep fabric of the economy. Even before this week's revision, unit labor costs had risen to such an extent that the Fed had been forced to stop citing their quiescent state as a rationale for its sanguine view on inflation (see "Surprise on the Doveside" August 9, 2006). Now, at 5% year-on-year, unit labor costs are rising as rapidly as they were in the first and third quarters of 2000 when the Fed feared a serious inflation threat and responded with economy-crushing interest rates. That's the path we are now walking.

Update to strategic view
US STOCKS: While better than expected growth should buoy prices in the near term, yesterday's sharp negative reaction to the rise in unit labor costs is a reminder that, ultimately, stocks are vulnerable to an inevitable shift in inflation expectations. As a hedge against the difficulty of calling the turning point in expectations exactly, strength should be taken as a selling opportunity. **CONGRESS CONTROL:** The GOP will lose House control in November by a narrow margin, but will hold on to Senate control.
[see Investment Strategy Dashboard]

We continue to maintain that the Fed made a critical mistake by pausing its rate-hiking program at the August FOMC meeting (see "Judgment Day" August 3, 2006). Evidence of more rapid economic growth than the Fed expects, and of more inflation pressure, will cause the Fed to resume hiking rates -- but having lost tempo by pausing, rates will now have to rise to levels that will pose a serious risk of recession, probably by next year. We've expected for the near term that the growth side of that story would keep an earnings-driven stock market rising -- and that's been correct so far (see "Update to Our US Equity Forecast" August 23, 2006). The question is when the inflation side of the same story will come to the fore, and trigger the inevitable reckoning with prohibitive interest rates -- and mark the end of the road for stocks.

There's no determinate answer, because it doesn't depend on the straightforward realities that the economy is expanding robustly and that inflation pressures are rising. Rather, it depends on the arbitrary decisions of a central bank that seems to have no model for coherently integrating these simple facts. Consider the conceptual quandary for the Fed presented by the sharp drop in crude oil prices over the last two weeks. On the one hand, the most recent FOMC statement, issued when the oil price was still near its high, said "the prices of energy and other commodities have the potential to sustain inflation pressures." So the drop in the oil price must be disinflationary. Yet at the same time, the same statement said that "Economic growth has moderated from its quite strong pace earlier this year, partly reflecting...energy prices." So the

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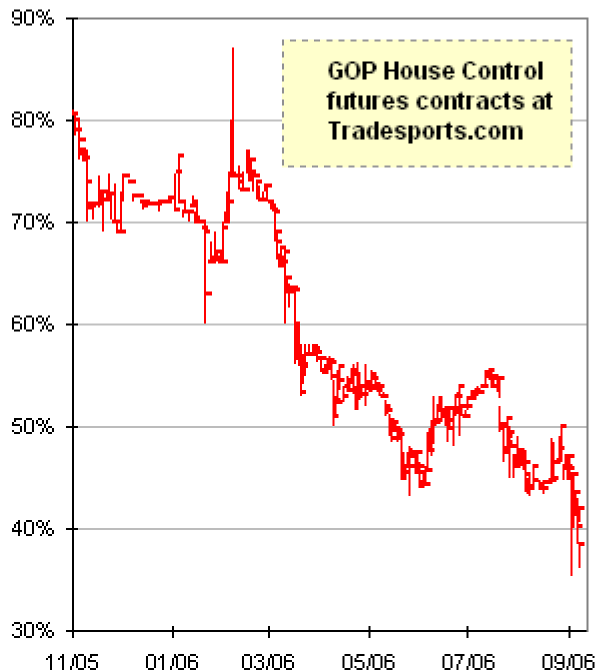
drop in oil prices will reaccelerate growth -- which, according to the Fed, is inflationary. Thus, for the Fed, the drop in oil prices is both disinflationary *and* inflationary!



GOP HOUSE CONTROL SLIPS AWAY The upcoming mid-term election is another long-term risk for stocks. The Republican party is failing to energize its base by at least trying to execute a simple checklist of conservative and pro-growth policy initiatives. Markets now face a real probability that the GOP will lose control of the House of Representatives. The online political futures contracts at Tradesports.com now give the GOP only a 38% chance of hanging onto the House. However, the futures show a 79% chance of holding on to the Senate. This comports with bottoms-up analyses that show the House with a far greater proportion of highly competitive races for Republican incumbents.

This is a negative development at the margin for growth, but it is not a catastrophe -- at least not an immediate catastrophe. With the 2003 tax cuts on dividends and capital gains having already been extended through 2010, the worst risk of the GOP losing congressional control has been taken off the table. Other than extending the tax cuts, GOP control had been unable to deliver any important pro-growth policy initiatives anyway -- so the cost of losing control is only in the risk of anti-growth initiatives that would otherwise have been blocked. And assuming that the GOP keeps its Senate majority, and with a Republican president still in the White House, the only anti-growth initiatives likely to get through would be those that emerge as populist runaway trains, such as Sarbanes Oxley. Such situations arise only rarely, but they become more likely during recessions -- and if we are correct that the Fed is likely to induce one by next year, the risks become non-trivial. This week's headlines provide a taste of the risks lurking over the horizon -- Senator Charles Grassley spoke favorably of eliminating the tax deductibility of stock option expense in excess of $1 million, and Senators Charles Schumer and Lindsey Graham vowed to force a floor vote on their bill to impose a 27.5% across-the-board tariff on goods imported from China.

BOTTOM LINE: On the plus side, and for the near term, the economic expansion is reaccelerating. For a stock market that is so undervalued as to be entirely earnings-driven, this puts a rising floor under prices. On the negative side, for the intermediate term, it's only a matter of time until the Fed interprets that reacceleration as inflationary, and must impose prohibitive interest rates to catch up from behind the curve. The economic penalties of the Fed's error will exacerbate political risk in a world with divided congressional control. It may be hard to know exactly when the modestly positive near term transforms into the negative intermediate and long terms, so short term strength in stocks is a selling opportunity. TM