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

FED SHADOW

The Frustrated Fed

Thursday, September 28, 2006

Donald Luskin

Where on Lenin's Tomb do Fed officials have to stand to signal their hawkish bias?

Recent conversations with Fed officials have given us some new insights. We are now more convinced than ever that the bond market is completely misreading the Fed as more dovish than it actually is, pricing for rate cuts that are simply not in the cards. At the same time we are more convinced than ever that the Fed has talked itself into being less hawkish than it ought to be, and that inflation pressures are being allowed to compound.

THE FED ISN'T HAWKISH ENOUGH While the Fed staff's models are forecasting a sharply moderating economy, and a consequent fall in inflation pressures, a preponderance of voting FOMC members nevertheless regard inflation as the "dominant" risk, to employ the term used in the minutes of the August 8 meeting. At the same time, the policymakers believe that this risk is easy to control through a combination of straightforward policy actions and public statements. Serious risk to growth from two years of rate-hiking, on the other hand, is believed to be more unlikely -- though should it eventuate, the policymakers are far less confident that they possess the tools to respond to it either quickly enough or effectively enough. So pausing in the rate-hiking cycle that began in June 2004 is a straightforward risk management exercise: the *likely but manageable* risk --inflation -- is being allowed to run, while the *unlikely but unmanageable* risk -- a serious slowdown -- is being addressed.

It all hinges on two incorrect premises. First, the Fed mistakenly believes that if a serious slowdown materializes, it will act *ipso facto* to restrain inflation pressures. But history shows no correlation between real growth and inflation (in fact, what little correlation one can find is negative). And second, the Fed mistakenly believes that if the slowdown *doesn't* materialize, that is has enough credibility to rein in inflation pressures on command, without hiking rates to growth-crushing levels. The positive response of various indicators of inflation expectations -- gold, commodities, the dollar, and TIPS spreads -- to Ben Bernanke's stern words about inflation in June have emboldened the Fed in this belief (see "Bernanke Arrives" June 6, 2006). But by the time that the Fed needs to put it to the test, inflation pressures will likely already have compounded to a point beyond the line in the sand that Bernanke drew in June. So it's far from

Update to strategic view
US BONDS: The Fed is frustrated by the bond market's misapprehension of the central bank's bias as dovish, and is likely to attempt to correct the misimpression. Bond prices will fall sharply as they are disabused of the certainty that the next Fed move will be a rate cut. **US STOCKS:** At new highs, we continue to fear that the Fed will eventually be forced to slow or reverse the earnings engine that is supporting stock prices. We don't know yet exactly when -- so in the meantime, be a scaled seller of stocks. **INFLATION PLAYS (GOLD, OIL, COMMODITIES, US RESOURCE STOCKS):** The speculative purge is over, bailed out by the inflationary "Bernanke put." An upside growth surprise, continued inflation, and a Fed of dubious credibility should move commodities higher. It's time to catch the falling knife. **US DOLLAR:** The same factors argue for a decline in the dollar versus foreign currencies.
[see Investment Strategy Dashboard]

certain that Bernanke's tough talk will be as effective a second time. We strongly suspect it won't be.

BONDS EXAGGERATE THE FED'S DOVISHNESS Fed policymakers are mystified by the fixed income markets' projection of dovish intentions into statements consciously intended to be read as hawkish. For example, we are told that after the August 8 FOMC statement was widely interpreted as surprisingly dovish -- even though the pause that began then was fully anticipated (see "Surprise on the Doveside" August 9, 2006) -- the minutes of that meeting released August 29 were deliberately crafted by the Fed to be a hawkish corrective (see "Denial" September 5, 2006). Yet that corrective was interpreted as just more dovishness, driving the 10-year Treasury yield to an even deeper inversion to the funds rate.

And we are told that bonds are missing the significance of Richmond Fed president Jeffrey Lacker's dissents at both the August 8 and September 20 FOMC meetings. Lacker is not the lone voice that he might seem. As a single dissenter on a committee of nine, he was in fact put forward deliberately as a stalking horse, being the FOMC member who most enjoys talking to the press, and the strongest advocate of a view that is held in some important degree by several other committee members. A vote reflecting the true extent of dissension would have damaged the committee's credibility, revealing that it is in fact deeply divided. The code for the true state of play employed in the minutes of the August 8 meeting was to say that the decision to pause was "a close call." It was also pointed out to us that it is not insignificant that there was no dissenter, single or otherwise, who advocated *cutting* rates at either of the last two meetings. Thus the "close call" was between *pausing* and *hiking* -- yet the bond markets now treat *cutting* as a foregone conclusion.

The fed funds futures market is priced for a small chance of a cut as soon as the December FOMC meeting, building to a near certainty by the March 2007 meeting. But for this to come to pass, we would have to see a rapid and severe deterioration of economic conditions. Starting from the Fed's present hawkishly biased risk management posture, no mere "moderation" of growth, to use the Fed's term, would do it -- all *that* deserves is a pause. A sharp housing slowdown is the only contingency now visibly in play that is capable of sufficiently moving the Fed to ease. We can't deny the possibility -- the conventional wisdom at this point is focused nothing less than an imminent housing Armageddon. But from our standpoint, we have to be skeptical of the likelihood of the eventuation any catastrophe that is as widely expected as this one -- ships are only sunk by icebergs that they *don't* see. In fact, the bearish housing consensus is so widespread we are tempted out of sheer contrarianism, if nothing else, to expect a substantial and immediate recovery in the sector. But even if, as more likely, what we get is an orderly retreat in housing, the bond market is *still* wrong: at most, the Fed will stay on pause, and even that only until inflation pressures become so pronounced that it has no choice but to resume its rate-hiking regime.

AMARANTH HIGHLIGHTS INFLATION RISKS While the Fed is drawing comfort and confidence from the decline in gold, commodity and energy prices, the revelation of Amaranth's distress underscores our contention that much of it has been due to speculative purging (see "Weak Gold, Strong Inflation" September 13, 2006). Once that purging has fully run its course, we expect the growing inflationary consequences of the Fed staying on pause -- combined with the upside growth surprise we expect over the last two quarters of this calendar year -- is likely to drive these markets back to their May highs. In fact, the ease with which Amaranth's positions were placed at a discount into strong hands, and the virtual absence of any significant systemic consequences in the speculative community or among the prime brokers that serve it, is itself a form of evidence of the inflationary environment in which we find ourselves.

During Alan Greenspan's long tenure as Fed chair, market difficulties like this were handled by means of the "Greenspan put." The Maestro's years were a tight-money regime, but liquidity was always provided when needed, such as after the stock market crash of 1987, the peso crisis of 1994, the Long Term Capital Management collapse of 1998, and the terrorist attacks of 2001. In this context, liquidity means the power to borrow enough money to fund one's way out of whatever trouble one is in. The "Bernanke put" works differently. That liquidity is there all the time -- whether one needs it or not. Last week Amaranth's problems were resolved -- and the rest of the world took its lumps in energy and other commodities -- without any particular intervention from the Fed. It happened the same way that markets easily absorbed the consequences of Hurricanes Katrina and Rita, and the collapse of Refco. The liquidity was there after those crises -- because it had been there before them, too. It's all helicopters all the time -- and it's inflationary. More liquidity supplied than liquidity demanded always is. Typically, inflation is defined as too much money chasing too few goods. In the case of the "Bernanke put" it is defined as too much liquidity chasing too few financial crises. Thus the Amaranth affair hardly signals the end of inflation-driven commodity speculation. It signals that all the necessary preconditions for continued speculation are very much in place.

BOTTOM LINE: Inflation pressures are compounding while the Fed stays on pause, and growth is likely to surprise on the upside -- especially in relation to the terribly negative expectations implied in the fixed income markets. In this light we reiterate two market calls that, candidly, have not so far been among our best. Most emphatically, we reiterate our call to sell long-term Treasury bonds. A hawkishly biased Fed that feels misunderstood as dovish will make continued efforts to correct the bond market. With yields now steeply inverted to the funds rate, these efforts could trigger a significant sell-off in bonds even without achieving anything like the full revaluation we ultimately expect. Even without a word from the Fed, soon enough an upside growth surprise and mounting inflation pressures will convince the bond market that the rate cuts it expects will, in fact, be rate hikes.

Second, we reiterate our bullish outlook for inflation plays such as gold, oil, commodities, US resource stocks (and our bearish outlook for the dollar). We've seen the boom in energy, and commodities in general, as being the joint product of global growth, geopolitical uncertainty and especially monetary inflation -- with a healthy dose of speculation thrown in. We've generally been successful in calling intermediate term tops when it seemed to us that speculative sentiment was cresting, as it did in crude oil as Hurricane Katrina struck (see "Water In The Streets" September 1, 2005) and -- spectacularly -- in natural gas, when Hurricane Rita struck a month later (see "Played Out" October 5, 2006). Unfortunately, we didn't see the last month's speculative purge coming with similar accuracy. Our forecast for growth to surprise on the upside, and for heightened inflation risk as the Fed stays on pause, has had us long and wrong this time around (see "If Only It Were This Easy" August 18, 2006). Our sense now is that there has been too much talk about a "collapse" in commodities and energy, too much conviction that the speculative cycle is over, and too much fear of systemic risk among hedge funds. Nothing has changed in our outlook for global growth, geopolitical uncertainty, or inflation -- and the "Bernanke put" is still there. So is it time to try to catch the falling knife in energy and commodities? It probably is, at least for a trade -- and possibly much more.

Finally, a word on stocks as the S&P 500 makes new recovery highs, and the Dow Jones Industrial Average flirts with all-time highs. During the sharp decline from the highs of last May, we said repeatedly to buy the dip -- expecting continued growth to drive earnings growth that would act as a rising floor under stock prices (see, for example, "The Out-of-Consensus Consensus" June 26, 2006). But now, with the Fed neglecting inflation pressures and underestimating growth, it's only a matter of time until draconian rate hikes -- which could have been avoided had the Fed not paused -- will slow or reverse the earnings engine supporting equities. We don't know exactly what will catalyze that, or exactly when. In the meantime, a prudent course is to be a scaled seller of stocks.