TrendMacrolytics

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

MACROCOSM

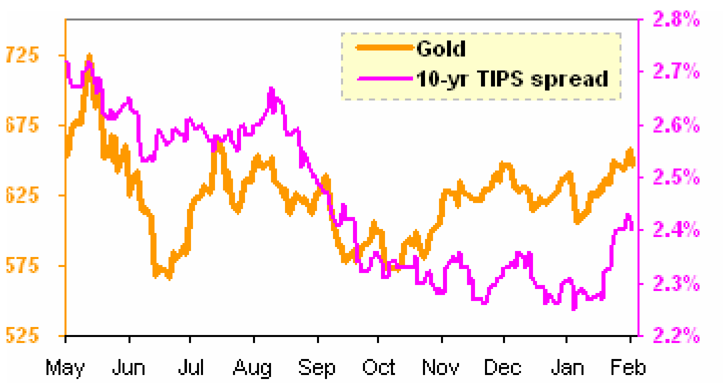
Gold Versus Goldilocks

Friday, February 2, 2007

Donald Luskin

The problem with this stock market rally is that inflation plays are leading it.

Stocks have made new highs. We are still expecting an important top in 2007, but we've been right so far to not over-react to small corrections, and to look for better opportunities to sell into strength (see "A Break in Trend" January 8, 2007). Stocks are being dragged higher by a rising floor of growing earnings expectations, itself fueled by a robust economic expansion, the true strength of which has been masked by highly publicized problems in two isolated areas of the economy -- housing and autos. We maintained all along that overall growth would surprise on the upside (see, for example, "Gut Check for Growth" November 2, 2006), and with Wednesday's GDP report making it official, that's just what growth did. But that surprise is laying the groundwork for the dynamic that will ultimately present a threat to growth, and will lead to the stock market top we expect this year.



The issue is that the "inflation plays" that we've favored over the last several months have led this latest move higher. Since last September when we said to "catch the falling knife" in commodities after the Amaranth hedge fund debacle (see "The Frustrated Fed" September 28, 2006), Basic Materials and Energy have been two of the three best-performing S&P 500 sectors (up 15.6% and 10.3%, respectively). Since the middle of last month, when we said to catch it again (see "Update to our Equity Sector Forecasts" January 11, 2007), they've again been two of the three best-performers (up 5.2% and 8.0%, respectively). At the same time, gold, the most monetary of all commodities, has made highs not seen since last July. The dollar has fallen on forex markets. And the 10-year TIPS spread has widened by 17

Update to strategic view

US STOCKS: We look ahead to a top in stocks when the Fed inevitably tightens. But that's an indeterminate time in the future, and for now the upside surprise in growth is sustaining a new gradual move higher.

INFLATION PLAYS (US RESOURCE STOCKS, COMMODITIES, GOLD, OIL, US DOLLAR): Inflation-sensitive markets have reacted to an upside surprise in growth, which has rendered the Fed more accommodative. Some of these markets are correcting today on an arguably slightly soft jobs report. But as growth continues to refuse to "moderate," we expect these markets to challenge their highs of last year (and the dollar to challenge its lows).

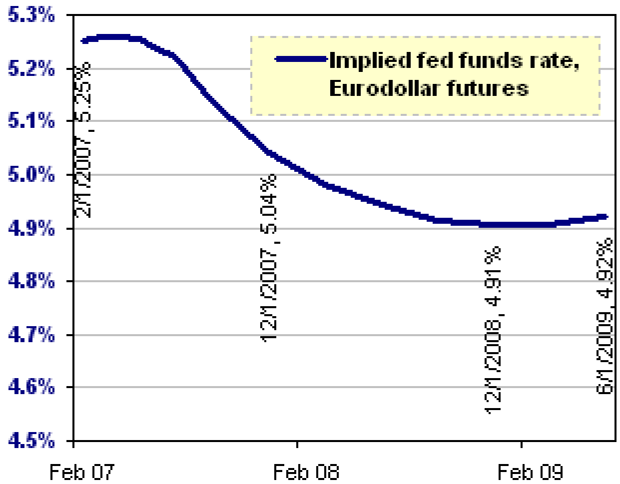
[see Investment Strategy Dashboard]

http://www.trendmacro.com
don@trendmacro.com
dgitlitz@trendmacro.com
tdemas@trendmacro.com

Offices:
Menlo Park CA
Parsippany NJ
Charlotte NC

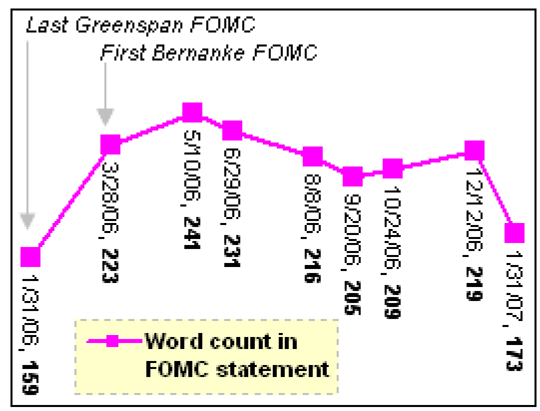
Phone:
650 429 2112
973 335 5079
704 552 3625

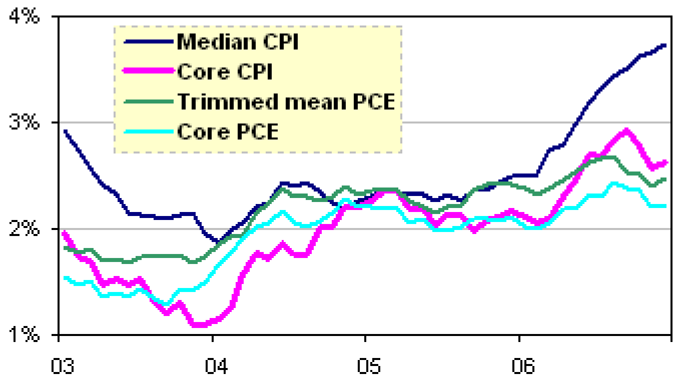
basis points, to its highest level in four months. Clearly, inflation expectations have been on the rise generally, and have accelerated markedly over the last several weeks.



Paradoxically, this has happened against the backdrop of sharply falling expectations for Fed rate cuts. Since early last December the interest rate futures markets have gone from expecting three rate cuts in 2007 to not even one. On the face of it, a less easy Fed ought to cause inflation expectations to drop, but that's just the opposite of what has happened. The resolution of this seeming paradox is that the economy has delivered a growth surprise larger than the shift in Fed expectations. That is, a Fed on pause when growth is accelerating may be more accommodative than a Fed that eases when growth is moderating. The interest rate futures markets say the Fed will pretty much be on pause as far as the eye can see, just cutting rates once late in 2007. The inflation-sensitive commodities markets are saying, given the upshift in growth, *that's still too easy, and it's just gotten even easier.*

In Wednesday's statement, the FOMC acknowledged the recent acceleration in growth -- indeed, how could it not (see "On GDP and FOMC" January 31, 2007)? But at the same time, the Fed stuck to its familiar story that it expects growth will moderate, and inflation along with it. The uncharacteristic brevity of the statement -- the least verbose of any under Ben Bernanke's chairmancy -- suggests that the Fed may be entering a period of re-examination in which it will do more thinking than story-telling. But it's not clear how long it will take for the Fed to think through what it will take to set aside its risk-control concerns about systemic risk arising from the housing cool-off, and focus instead on reining in inflation that is likely to be far more persistent than it now says it expects.





While the Fed stays accommodative as it thinks and rethinks, inflation marches on. Yes, headline inflation indices have moderated somewhat thanks to the drop in oil prices since mid-2006. But core measures -- that better capture the longer-term structural inflation dynamics of the economy -- remain at unacceptably high levels, with some measures making new highs. The Fed continues to warn of upside inflation risk, and to reiterate the expectation -- the hope, really -- that it will moderate. But the burden of proof is on those who hope. There is no tangible sign of moderation, and the recent resurgence of inflation expectations does not bode well for the future.

BOTTOM LINE: For the moment, it's Goldilocks -- a reaccelerating economy and an accommodative Fed doing nothing to get in its way. But it could be gold that brings Goldilocks to an end. Every day the Fed stays on pause at rates too low for the robust growth we're experiencing, more and more inflationary pressure is pumped into the pipeline. Gold has dropped this morning on an arguably somewhat soft jobs report, giving some relief to the economy bears and the inflation doves. But we expect growth will continue to be robust, and continue to keep the Fed implicitly accommodative as long as it stays on pause. Gold will continue to rise, possibly soon testing last year's highs at 725. Other inflation indicators -- the TIPS spread, oil, forex, and so on -- will do likewise. Stocks will drift higher, led by the inflation plays. Statistical inflation indices will resume their uptrends. The day will come when Ben Bernanke wakes up in the morning and decides that inflation expectations have come unhinged, and that the housing cool-off really isn't going to destroy the economy after all. Then it will be time for the Fed to hike rates, and the leadership of the inflation plays will come to an end. Depending on when it happens and how inelegantly the Fed handles it, the expansion and the bull market may come to an end, too.TM