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

FED SHADOW

A Dearth of a Thousand Cuts

Tuesday, September 18, 2007

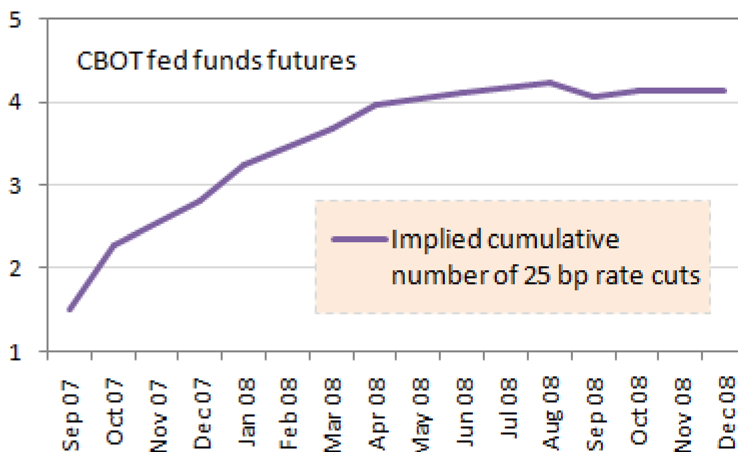
Donald Luskin

Bernanke will cave to market pressure and cut the funds rate once, but a neutral bias will disappoint the doves about future cuts.

Market-implied expectations are reflecting certainty of at least a 25 bp fed funds rate cut at this afternoon's FOMC meeting, with a 50/50 possibility of 50 bps. For the last two weeks we have expected 25 bps (see "Cut or No Cut" September 5, 2007). We don't believe any cut at all is necessary either to reliquefy credit markets or to protect against overall economic weakness. We think Ben Bernanke believes as we do. Nevertheless, we expect that the FOMC will bow to expectations, if for no better reason than to not shock sentiment that, while substantively recovering from the worst depths of panic, is still fragile.

Update to strategic view
FED FUNDS: We expect the FOMC to cut the fed funds rate by 25 basis points. However, we think that the FOMC will adopt a neutral bias, not the dovish bias that the market expects. **INFLATION PLAYS: US RESOURCE STOCKS, GOLD, COMMODITIES, OIL, AND US DOLLAR:** A neutral bias at today's FOMC meeting could be a short-term disappointment for markets tuned to the potential of an inflationary policy error. But even the Fed on hold at 5% for a very long time will have profound inflationary consequences, and should be supportive of the inflation plays. If a dovish bias is adopted, it's a whole new leg up (or for the dollar, down).
[see Investment Strategy Dashboard]

For us the only question for today is how the FOMC will guide longer-term expectations in the credit markets. Looking a year out, the fed funds futures markets are priced for a total of four 25 bp rate cuts. While not wanting to upset sentiment, we think the FOMC today will begin today to take a "let them down easy" approach, by beginning to signal that it intends to keep its options open. The most straightforward way to do this will be for the FOMC to move from its long-standing hawkish bias to a neutral bias -- that is, stating that while the risk to growth has increased, that only brings it into balance with the risk of inflation. This will disappoint expectations



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

Copyright 2007 Trend Macrolytics LLC. All rights reserved. This document is not to be forwarded to individuals or organizations not authorized by Trend Macrolytics LLC to receive it. For information purposes only; not to be deemed to be recommendations for buying or selling specific securities or to constitute personalized investment advice. Derived from sources deemed to be reliable, but no warranty is made as to accuracy.

somewhat, but it actually only reaffirms the strong implication of the FOMC's August 17 intermeeting statement announcing the cut in the discount rate, in which an increased risk to growth was acknowledged but the overall balance of risks was artfully not mentioned at all (see "A Surgical Strike" August 17, 2007).

Our view is that today's 25 bp cut will likely end up being the only cut (see "Did Somebody Say 'Inflation'?" September 13, 2007). We don't expect that the economy will be sufficiently weak to motivate the Fed to cut rates further, and we don't believe that the central bank will be comfortable with further rate cuts as a form of "insurance" against potential but unrealized weakness. Gone are the days when, as throughout 2003 and 2004, Ben Bernanke could justify low rates as a free put to protect against deflation -- free on the grounds that there was sufficient "slack" in the economy to assure that there would be no inflationary consequences arising from such a sustained accommodative posture. For one thing, there is scarcely any "slack" in today's economy -- with an unemployment rate of 4.6% and little tangible evidence of any significant slowing of growth. And Bernanke can't not wonder whether there was something wrong with his "slack" theory in the first place. He has to be troubled by the emerging consensus that the Fed's having been too easy for too long was responsible for credit and housing booms, the reversal of which are causing so much distress today. That consensus -- reflecting an analysis we have espoused for several years -- has gained traction over the last several days as former Fed chair Alan Greenspan, with the release of his tell-all book, confessed that he, and by implication Bernanke, too, were asleep at the switch while the seeds of today's dislocations were being sown by the Fed.

And while official inflation statistics appear reasonably tame, Bernanke cannot be incognizant of upside inflation risks. For one thing, growth has yet to moderate to an extent that would provide substantial comfort on inflation risk within the Fed's output gap model. For another, important inputs that figure in the Fed's cost-push model of inflation are going the wrong way -- oil is at all-time highs, and the foreign exchange rate of the dollar is at all-time lows. Finally, Bernanke believes that inflation expectations are critical to forming future actual inflation, and some markets reflecting those expectations have moved up dramatically, especially gold and commodities. Since the August bottom in equities, the energy and materials sectors have been respectively the best and second-best performers in the S&P 500. Bernanke's most often cited expectations indicator, the TIPS breakeven spread, has hardly moved at all. But Bernanke ought to know, since Fed economists have published the research, that inflation-protected Treasuries can give inaccurate signals because the markets for them are less liquid than those of their nominal counterparts -- in times of illiquidity such as today's credit crisis, the illiquidity discount impounded in TIPS prices can deepen, masking upward changes in inflation expectations.

Bernanke has already lived once through a surge in inflation expectations. In late April 2006, shortly after he took office as Fed chair, he told Congress, that he would potentially not raise rates even though he perceived inflation risk, in order to buy time to gather information on risks to growth -- a nonchalance about inflation that pragmatic Fed chairs may indeed practice, but that credible ones should never preach (see "On Bernanke's Testimony" April 27, 2006). Several days later CNBC's Maria Bartiromo reported Bernanke had recanted this all-advised statement, having told her he was "misunderstood" -- buy according to our sources, Bernanke denies saying this (see "Lesson Learned?" May 3, 2006). With the new Fed chair sending such mixed signals, in early May inflation expectations markets came violently to life. Gold hit cycle highs at $725, the dollar fell to within pennies of new cycle lows, the 10-year TIPS spread advanced to within a basis point of all-time highs, and the S&P 500 entered into a sharp correction. In early June Bernanke gave a sternly hawkish speech about the importance of keeping inflation expectations well anchored, and that was enough to turn the tide (see "Bernanke Arrives" June 6, 2006). In August, when the Fed went on indefinite hold at a funds

rate of 5.25%, Bernanke embarked upon a policy that did precisely what he warned Congress he would do -- yet inflation expectations markets remained quiescent because Bernanke had apparently struck a balance in which he could act dovish but talk hawkish. But now the present credit crisis, and its potential to spill over into the general economy, has upset that balance -- the action is getting more dovish, and the hawkish talk seems not to work anymore.

Gold, and the other inflations expectations markets, are seeing something new. What is gold seeing, as it challenges the highs at $725 marked last year, the last time Bernanke was tested? We think it is seeing credit markets that, while priced in ways that are very distressing to certain players who made ill-advised levered bets, are not suffering for want of monetary liquidity -- the Fed and the other central banks of the world are already supplying that through open market operations at existing rates. We think gold is seeing a central bank that is bowing to intense market expectations, and cutting interest rates when there is no need to do so. We think gold is seeing what Alan Greenspan is seeing when he told the *Financial Times* yesterday that under his chairmancy, "We were not worried about inflation resurgence, but now you have to be. You have got to be a lot more careful in lowering rates in response to crises." So much for the consensus that Greenspan would have reacted "preemptively" in the present crisis, while Bernanke has dragged his feet (see "The Greenspan Myth" September 13, 2007). For that matter, gold is seeing what all the Fed officials who have spoken recently are seeing -- that the factors making official inflation statistics seemingly benign may be only transitory.

We've been bulls on oil, commodities, gold and US resource stocks (and bearish on the dollar) -- the "inflation plays" -- for quite some time (see, for instance, "The Frustrated Fed" September 28, 2006). We've expected that, if the Fed stayed on hold at 5.25% long enough, eventually all the inflation-sensitive markets would challenge their levels of May, 2006 -- we've called that Ben Bernanke's "line in the sand" (see "Bernanke's Quagmire" August 7, 2006). In some client meetings, with tongue at least partially in cheek, we've even made an unofficial forecast that gold is heading right through that line, and all the way to $1000. Now the stakes are higher. Now we're not just talking about the Fed staying on pause too long, but about cutting rates -- and possibly more than once, if the expectations markets turn out to be correct. One unnecessary rate cut is probably enough to sustain the gains that the inflation plays are making here. If the FOMC is especially clear that today's cut is one-and-done, then there could be a negative reaction in the inflation plays, although even in that scenario considerable inflation pressures would remain because the Fed would probably stay on hold at 5% for a very long time. But if the Fed adopts a dovish bias, or otherwise commits itself to a series of rate cuts, then we'll take our tongue out of our cheek -- gold will be at $1000 before you know it.

BOTTOM LINE: We expect the FOMC to cut the fed funds rate by 25 basis points. However, we think that the FOMC will adopt a neutral bias, not the dovish bias that the market expects. A merely neutral bias could be a short-term disappointment for inflation plays, markets now tuned to the potential of an inflationary policy error -- US resource stocks, oil, gold, commodities and forex. But even the Fed on hold at 5% for a very long time will have profound inflationary consequences, and should be supportive of the inflation plays. If a dovish bias is adopted, it's a whole new leg up.