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MACROCOSM

Honey, I Shrunk The Dollar

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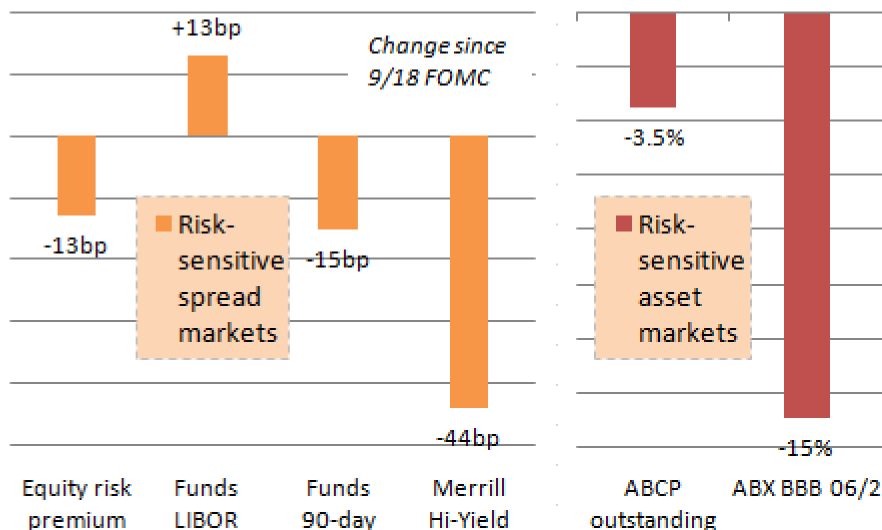
The Fed has kicked inflation pressures into high gear, pretty much for no good reason.

Update to strategic view

US MACRO: The Fed is easy again. Growth was never as much at risk as the Fed fears, which makes the September rate cut an accelerant of both growth and inflation. The Fed will have to take back the last rate cut sooner than markets expect, and may eventually have to move to substantially higher rates to correct a grave inflation error.
US STOCKS, US RESOURCE STOCKS: Stocks should continue to fight back to the July highs and beyond. The resource sectors -- which are both growth-sensitive and inflation-sensitive -- lead the way.

[see Investment Strategy Dashboard]

The Fed's cutting the funds rate by 50 bp on September 18 hasn't done much overall to relieve stress in credit markets, at least not much beyond what had already been achieved before the FOMC acted. On the plus side of the ledger, since the rate cut the junk bond spread, the equity risk premium and the spread between the funds rate and 90-day Treasuries have all narrowed. Yet at the same time, the spread between LIBOR and the funds rate has widened, asset-back commercial paper outstanding continues to shrink, and the ABX indices of structured debt product based on subprime mortgages have fallen to near new lows. In our view this is not surprising, since we have argued all along that the crisis in credit markets is a long-overdue and mostly healthy correction of excessive risk tolerance, and that the Fed's function as a lender of last resort, to help markets through a painful but necessary adjustment, has little to do with the funds rate (see "A Surgical Strike" August 17, 2007).



But the Fed wasn't thinking only of credit markets *per se* when it cut rates, but rather on the spillover effects of constrained credit into the housing market and the general economy (see "The Fed Gets the Yips" September 19, 2007). Here, faced with the fear of a slowing jobs

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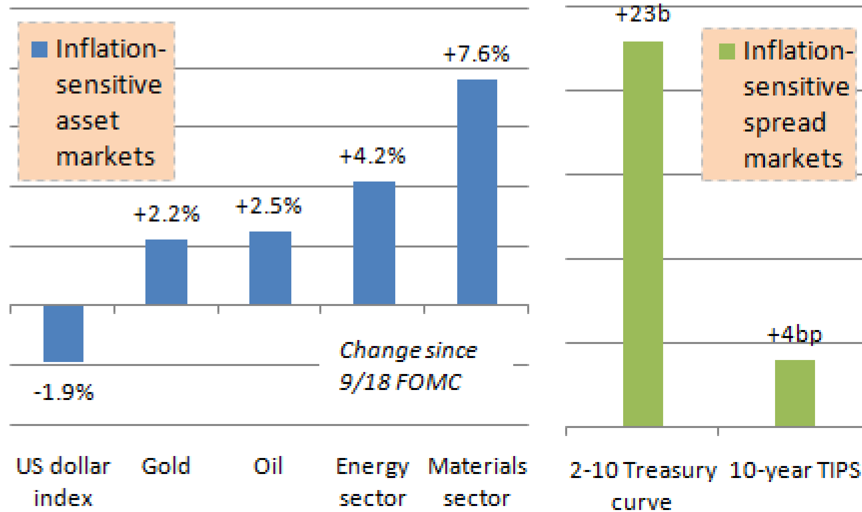
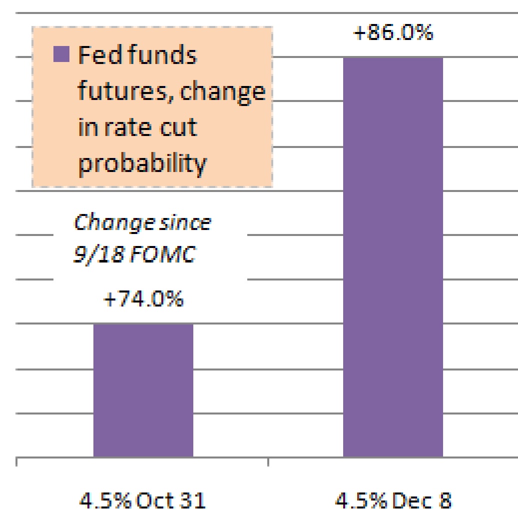
market as housing activity and wealth contract, it seems the Fed has done precisely what Ben Bernanke pledged *not* to do in his very first speech as Fed chairman -- that is, to exploit the Phillips Curve to increase growth and employment at the expense of inflation (see "Is Ben Bernanke a Phillips Head?" March 1, 2006). Markets appear to believe that Bernanke's approach will work. Since before the Fed cut rates last week, the S&P 500 has risen 3.8% to new recovery highs, just 1.1% below the all-time highs notched in July.



But we had expected stocks to recover all along, even when we expected -- wrongly, as it turned out -- the Fed wouldn't cut the funds rate (see "Stocks Don't Need a Rate Cut" August 31, 2007). Coming in to the September 18 FOMC meeting, growth was already more robust than the Fed apparently believes or fears -- with consensus forward earnings estimates continuing to rise, credit markets finding their footing, and the flow of macroeconomic data having generally been quite positive. The only exception has been a single payroll jobs report that has since been flatly contradicted by three weeks of falling jobless claims (see "Bad Jobs" September 7, 2007). So in our view, the rate cut was unnecessary -- which means that the Fed has sent the US dollar to all-time lows on forex markets for no reason at all.

There is no doubt that the dollar's drop since the FOMC meeting reflects the markets' appraisal of the inflationary consequences of the rate cut. Over the same period, all inflation-sensitive markets have delivered versions of the same judgment. Gold and oil have risen by about the same percentage amount that the dollar has fallen, making new 27-year highs and new all-time highs, respectively. The TIPS spread has widened, and the Treasury curve has steepened (see "Did Somebody Say 'Inflation'?" September 13, 2007). The energy sector and the materials sector -- companies that live at the intersection of growth and inflation -- have both outperformed the S&P 500 since the rate cut. And as we predicted they would, they've been far and away the best performing sectors since the August 15 bottom for stocks (see "Thoughts After a Very Rough Week" July 30, 2007).



We acknowledge that, with the crisis in credit markets, *risks* to growth have gone up. But our central forecast remains what it was before the crisis began -- that growth ex-housing will continue to be quite robust. Even at a funds rate of 5.25% the Fed was somewhat accommodative, and had certainly done nothing to correct for several prior years of extreme easiness. Now, with a surprise 50 bp rate cut under its belt, and with market expectations for further cuts at the October and December FOMC meetings having sharply risen since the September meeting, the Fed is easy again. So for growth in the

short term and inflation in the long term, we'll continue to describe the Fed's posture using the jargon of crime scene investigations in cases of arson -- as an "accelerant" (see "Cut or No Cut" September 5, 2007).

BOTTOM LINE: The Fed is easy again. Growth was never as much at risk as the Fed appears to fear, which makes the September rate cut an accelerant of both growth and inflation. We expect that the Fed will have to take back the last rate cut much sooner than markets expect, and may eventually have to move to substantially higher rates to correct the inflation error that has been made. Stocks should continue to fight back to the July highs and beyond, as it will take some time for the dark side of the Fed's inflationary error to be generally understood. The resource sectors -- which are both growth-sensitive and inflation-sensitive -- will continue to lead the way.