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MACROCOSM

Fannie and Freddie Fan Inflation Fire

Friday, July 11, 2008

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The scariest consequence of the GSE panic is renewed risk of a worst-case inflation scenario.

Update to strategic view

US MACRO: The panic engulfing Fannie and Freddie has moved inflation risk to a critical hinge point. A worst-case scenario is becoming clearly possible if the Fed confirms market perceptions that the crisis is taking out its ability to move policy back toward neutral.

FED FUNDS: An August FOMC rate hike is off the table in the face of the Fannie/Freddie crisis. But a solution will probably be found shortly, and so current expectations for a single 25 bp hike by year end are likely too conservative, given increasingly obvious inflation risks.

[see Investment Strategy Dashboard]

As we feared might happen, inflation risk is being ratcheted back up to an alarming degree today (see "From Correction to Test to Bear Market" July 10, 2008). Gold today is trading around $960, its highest level since the immediate aftermath of the Bear Stearns debacle in March; the dollar is fully retracing its recent appreciation and returning to near all time lows against the euro, and crude oil has touched a new record above $146. At this point, the panic that has engulfed Fannie Mae and Freddie Mac -- based, it seems to us, on the market's taking a suddenly and arbitrarily negative view of facts that have been in place now for months -- seemingly is taking out any near-term chance for the Fed to begin restoring monetary equilibrium. But the foundations of this inflation risk breakout have been building for the past several weeks, as the Fed's credibility to back its words with action was increasingly being put in doubt (see "Bernanke's Test" July 3, 2008). The Fannie/Freddie crisis is acting as the capper on the process of closing off the Fed's perceived capacity to initiate the policy normalization process.

During the run-up last month in the anticipated pace of Fed rate hikes, the bearish take was that the markets and the economy were too fragile to withstand any taking back of the 325 basis points in rate cuts put in place since last September. But even before the market's latest panic attack, it became painfully clear that the reversal of those rate-hike expectations was no elixir for the markets or the economic outlook. In fact, the deterioration of market confidence which has characterized the trading environment appears in important respects to have been rooted in the risk that the Fed would *not* hike rates, that is, that it would be too timid to take the action needed to begin moving policy back toward neutral.

By around the middle of last month, we were heartened by the fact that fed funds futures were pricing an increasing probability of initiation of the rate hiking process at the August 5 FOMC meeting, with the December contract showing a growing chance for as much as 100 bp in hikes

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by year-end (see "This is the Turn" June 11, 2008). But in the weeks since, those expectations have receded to the point where the futures are now discounting less than a 15% probability of a first rate hike in August, with the December contract fully priced now for only one 25 bp hike.

The acceleration of tightening expectations last month came with considerably more hawkish notes being sounded by Fed chairman Ben Bernanke. First, he acknowledged the inflationary implications of dollar weakness (see "The Bernanke Awakening" June 5, 2008), and soon after he pledged to "strongly resist" an erosion in long-term inflation expectations, which to this point have already shown considerable erosion (again, see "This is the Turn"). Soon enough, though, the staying power of this new-found hawkishness was being called into question, first with stories planted in the media suggesting the Fed remained cautious about the economic outlook and stability of financial markets (see "Hikes are Coming, and Not a Moment Too Soon" June 19, 2008). Then, the FOMC statement late in the month was widely seen as falling short of the tough inflation-fighting tone that was hoped for (see "Bonds Wish, Stocks Worry" June 26, 2008).

The worst day of the slide into bear market territory came the day after that FOMC meeting, with the S&P 500 losing 39 points, or 2.9%. On the same day, June 26, crude oil hit a then-record $139.64, gold had its biggest percentage gain in two years, up 3.8%, more than $33, and the dollar dropped broadly on foreign exchange markets. Reporting on the stock market action that day, the *Wall Street Journal* said "some investors expressed concern that the Federal Reserve …could be in a tough spot: needing to raise rates to fight inflation, but reluctant to do so for fear of stifling the economy. That worry helped stoke inflation fears and weighed on the dollar." The same set of circumstances prevailed on two of the other biggest down days for stocks in this downturn, June 20 and July 2, with an S&P drop of more than 20 points on both days accompanied by rallying gold and crude and a slumping dollar.

But amid this general agreement that the Fed will be stuck in an easy money posture indefinitely, there have been some encouraging voices from within, suggesting that the chances for corrective near-term policy action haven't been entirely closed off. In remarks yesterday, Kansas City Fed president Thomas Hoenig, who has not previously stepped out as a hawkish Fed voice, called for getting rates back to neutral "as quickly as possible." Importantly, Hoenig noted that with the overnight rate at 2%, a number of the rate cuts could be reversed without getting policy into a posture that could be considered tight. "Two percent is accommodative; 2-1/2 percent is accommodative. So there is room to move back toward neutral without becoming tight." Hoenig also stated that "it is important to understand that we are in an accommodative position and the implications of that are the inflation we have will most likely continue in the future." And as far as the ties between monetary policy and the financial market turmoil are concerned, Hoenig said, "You expect too much from monetary policy if you think it can solve the problem, and if you try and make it solve the problem, you create a new set of problems."

So, there are still some grounds for the hope that a reasoned, responsible approach might yet prevail. And today, while the fate of world seems to be hanging on the two crippled mortgage giants Fannie and Freddie, it's conceivable that the panic could be relieved as quickly as it developed. One option for stabilizing the situation might involve the Fed devising a liquidity facility much like the one it put in place for the primary dealers following the Bear Stearns collapse -- call it GSECF, the Government Sponsored Enterprise Credit Facility. That would give Fanny and Freddie the ability to at least take the risk of difficulties in short-term funding as they find a way to build a capital cushion against the risks in their portfolios. And it would give the Fed added flexibility to pursue an appropriate policy course, freed from the belief that it must remain in an inflationary posture to weather the storm.

BOTTOM LINE: The panic engulfing Fannie Mae and Freddie Mac has moved the inflation risk environment to a critical hinge point. From here, a worst-case scenario is becoming clearly possible if the Fed confirms market perceptions that the crisis is taking out its ability to move policy back toward neutral. An August FOMC rate hike is off the table in the face of the crisis. But a solution will probably be found shortly, and so current expectations for a single 25 bp hike by year end are likely too conservative, given increasingly obvious inflation risks.