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MARKET CALLS

Investing at the Brink

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Picking the winners and losers as the Fed sleepwalks at the edge of inflation.

Our report yesterday outlined our reaction to **the Fed's** statement yesterday reiterating their commitment to keep interest rates low for a "considerable period." In our view the Fed's position shows reckless disregard for numerous indicators of imminent inflationary risk (see "Desperately Seeking Inflation?" October 29, 2003). This report is a follow-up, discussing the impact of the Fed's position on various investment markets.

The bear case for Treasuries is stronger than ever, and we reiterate our **Model Position short 10-year Treasury notes**. The Fed's intransigence delays somewhat the day of reckoning for investors holding the "carry trade" -- the leveraged position long Treasuries, designed to harvest today's unnaturally steep yield curve. But that's only a temporary stay of execution, or more precisely, the Fed's shaky commitment to play the music just slightly longer in what is inevitably a game of musical chairs. The Fed *will* raise rates at some point, and we continue to believe it will do so sooner than the market expects. And when it does, it will likely be because the Fed suddenly sees itself as being "behind the curve" -- which it will indeed be (as it almost always is) -- which means that the rate hikes will be aggressive. Treasury yields will rise all the more, then, because by that time what is now only inflation risk will have to be priced as inflation reality, and probably a lot more inflation reality than the Fed now wants.

Because we see rate hikes coming sooner and more aggressively than the consensus does, we reiterated our **Model Position short June Eurodollar futures**. They are currently forecasting a fed funds rate next June less than 50 basis points higher than today -- and we feel that is far too conservative an estimation.

Shorter-term, though, the Fed seems intransigently on hold. So at this point our speculative **Model Position short December Fed funds futures** is highly unlikely to pay off. We're going to close out the Model Position, taking the small loss on a trade initiated as a "nearly free option" on the remote but non-zero possibility that the Fed would hike rates this calendar year. With only one **FOMC** meeting to go this year and so little sign of enlightenment at the Fed, we see no point in bearing *any* continuing risk in this position now.

Our approach to equities is more complicated. We discussed in a *TrendMacro Live!* note yesterday what might happen if the Fed took the opportunity of yesterday's FOMC meeting to signal that it is pulling back from the inflationary brink (see "*Live!* on FOMC and Equities" October 28, 2003). We suggested that equities would initially drop on the conventional wisdom's perennial fears that rising rates would abort the recovery -- but that stocks would quickly recover and move higher when it is appreciated that rising rates are nothing but the natural and necessary reflection of economic growth. But the Fed *didn't* pull back from the brink, at least not more than microscopically. So... now what?

What we've called the "inflationary brink" is a *risky* place for the Fed to be, but until they tumble over the edge, it's a very *good* place to be. It's a risky sweet-spot, but it's still a sweet-spot. In

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fact, the only thing wrong with the brink is that it's risky. We can think of it as the place where the Fed is creating as much liquidity as possible -- thus enabling the maximum number of potential transactions in the economy -- subject to a no-inflation constraint. Until that constraint is violated, the Fed is doing everything it can to enable growth -- as we've seen from the breakaway performance of some of the most growth-sensitive equity sectors. In fact, if the Fed employed better operating mechanisms -- such as targeting prices rather than interest rates -- it could live safely at the brink all the time, and the growth rate of the US economy would be permanently raised as a result.

So unlike the case with bonds -- in which the Fed's brinksmanship is a no-win proposition resulting in inevitable losses regardless of whether the Fed falls over the edge *or* pulls back -- stocks have a way to win here. The reality is that, so far, what the Fed has been doing is growth-optimal -- if it just weren't for the risk. The presence of that risk has probably contributed more than any other factor to the slowdown in the market's recovery off the March bottom -- but even with that slowdown in the *rate* of recovery, the fact is that the markets were at new recovery highs as recently as two weeks ago.

So it's risky out there for stocks -- but as the old joke goes, "so far so good." Thus we are reiterating our 80% equity-exposed posture in our **Model Position long the S&P 500**. But while we are enjoying this bumpy overseas flight at the moment, we are glad to be seated in an exit row, well aware that our seat cushions can be used for flotation in the unlikely event of what is euphemistically called a water landing. TM