TrendMacrolytics

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The Rate Stuff

Wednesday, January 5, 2005

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The new year begins with a rate scare for stocks -- and a buying opportunity.

By the end of last year everything had pretty much fallen into place according to our expectations -- based on our view of an economy in expansion, but having been bedeviled by a "bubble of fear" driven by political risk. Stocks had a good year, with a total return of 11.9%, closing at the highs after a second half recovery as the election resolved favorably (that return is just slightly lower than the average for a fourth year of the presidential election cycle). Oil had pulled back sharply from its pre-election speculative peak. Inflation, as measured by core CPI, had pulled above 2% on a year-over-year basis. And **the Fed** had hiked interest rates like clockwork at every **FOMC** meeting since June's.

There's just one corner of the carpet that didn't get nailed down in 2004 -- bonds. The 10-year Treasury finished the year at yields so absurdly low that the marginal taxable investor now buys them at prices implying an expected after-tax after-inflation loss. The bond market still hasn't accepted the idea that the Fed is going to keep raising rates, meeting after meeting -- if not simply to follow through on a repeated commitment to restore today's still very low rates to normality, then to address an inflationary threat that we see the Fed hinting about with increasing intensity (see "Dollar Rally?" January 4, 2005).

The sharp drop in stocks in the opening days of the new year has corresponded with signs of a belated shift in rate-hike expectations -- reflected in interest rate futures, commodities (notably gold) and currencies. Admittedly, we've been calling for such a shift for quite some time now, and we've always said that when it comes there will be a superlative buying opportunity in stocks. The moment could finally be near at hand.

The conventional wisdom is that economic expansion and rising stock prices are the product of Fed "stimulus" through low official rates, and that rising official rates are, perforce, a barrier to growth and advancing stock prices. We believe that this is a fundamental misconstruction of the role of interest rates and money in the economy. Economic expansion requires the availability of capital, but the Fed cannot create or destroy capital, nor affect its long-run real cost. All the Fed can do is interfere, a lot or a little, with the economy's natural process of pricing capital -- both by directly distorting the price of capital through administered interest rates, and by destabilizing the value of the monetary unit of account in which all capital and all goods in the economy are priced. The Fed is doing its best when it interferes the least, confining its role to that of *croupier* -- providing just the right amount of chips to meet the needs of the players at the table.

Thus falling official rates are not necessarily good and rising official rates are not necessarily bad -- it's a matter of whether a given change moves the Fed toward the "right" interest rate, or toward the "wrong" interest rate. "Right" rates are those that track the natural price of capital in the economy, and result in transactions between the market and the Fed that cause the Fed to supply just the right amount of money liquidity demanded by the economy, without inducing

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either inflation or deflation. "Wrong" rates are those that conflict with the natural price of capital, triggering transactions that result in excessive or deficient money liquidity and induce inflation or deflation. Now, against the backdrop of an economy that is performing very well, today's still historically low rates are "wrong" -- they are triggering transactions that are resulting in excessive dollar liquidity, as evidenced by the last two years of rising commodity prices and falling dollar prices on forex markets, and the last year of rising inflation as measure by the CPI and PPI.

The stock market doesn't want *low* rates -- it wants the "right" rate. Yes, low rates make stocks look cheap in dividend discount models. But low rates that are "wrong" reduce the dividend growth expectations in those same models. And "wrong" low rates aren't sustainable anyway. There's always a payback when "wrong" low rates that stay too low too long end up as "right" high rates, driven higher when inflation expectations inevitably shift upward. In a nutshell, what stocks want is the "right" rate that maximizes *real* growth potential and minimizes monetary uncertainty.

But that's not the way most economists think about it. So if this is, indeed, the long-awaited onset of a fundamental expectations shift toward higher rates, expect lots of hand wringing about the end of "stimulus." And expect a rocky moment for stocks while those who insist on misunderstanding the role of the Fed also insist on selling stocks too cheaply. It won't be long until the expectations shift is complete, and recovering stock prices give those who misunderstood a little lesson in economics. TM