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MACROCOSM

Easier and Easier

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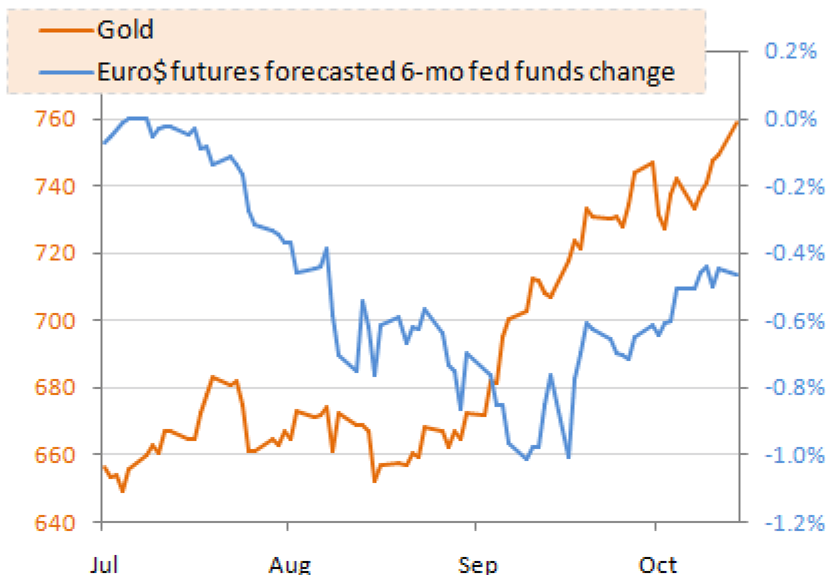
How come inflation plays are soaring while Fed rate cut expectations are diminishing?

Update to strategic view
US RESOURCE STOCKS: Energy is now the best-performing sector since the July top, and energy and materials are by far the best performers since the August bottom. A brief speculative correction is likely in store soon, but with growth intact and the Fed committed to easy money as far as the eye can see, these inflation-sensitive sectors should continue to be the best performers. **US STOCKS:** A scare over high oil prices may well trigger a reaction in stocks soon, but with the Fed easy and growth intact, we expect it will be only a brief correction.
[see Investment Strategy Dashboard]

In a speech last night, Fed chair Ben Bernanke gave an atypical acknowledgement to market-price indicators of inflation, saying, "On the inflation side, prices of crude oil and other commodities have increased somewhat in recent weeks, and the foreign exchange value of the dollar has weakened." This would seem to be quite an understatement, with crude oil at all-time highs, gold higher than it has been on any but two single days in history, and the dollar barely above the all-time lows established just two weeks ago. But the Fed is now committed to what Bernanke characterized last night as "risk-management considerations," which translates as an easy money policy stance designed to prevent a deepening housing slump from infecting the broad economy. With that mind-set, world-record oil prices won't be seen as an inflation problem, but rather as a threat to growth, to be solved with more inflationary easy money. Bernanke is well aware of the role that dynamic played in fueling the inflation of the 1970s. Nevertheless, he had little choice last night but to claim that "overall, the limited data that we have received since the September FOMC meeting are consistent with continued moderate increases in consumer prices." So



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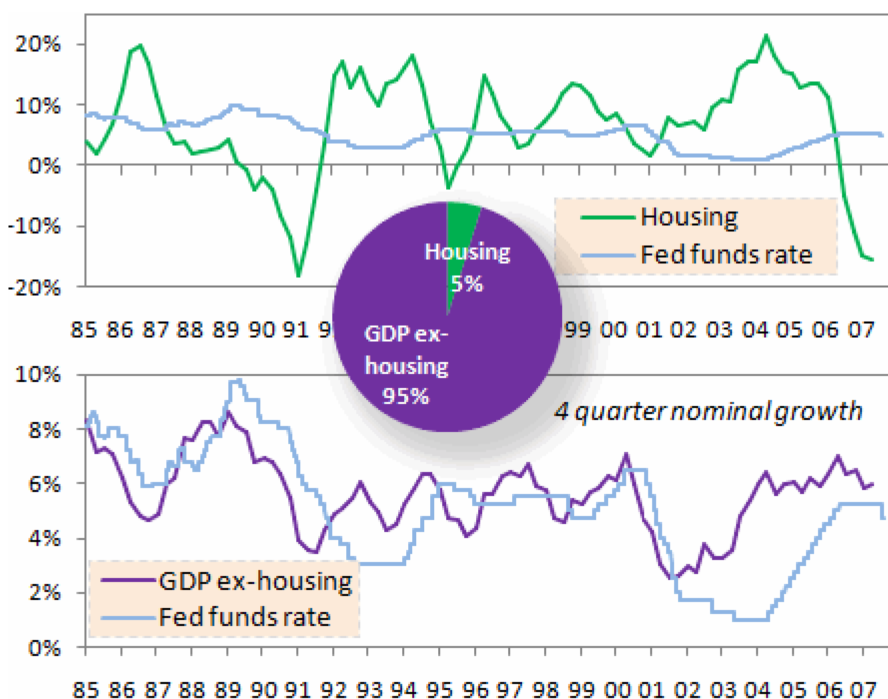
on the subject of inflation, the Fed remains in denial -- an increasingly willful denial (see "It's Not Just a River in Egypt" September 28, 2007).

A remarkable attribute of the behavior of commodities, the dollar, and inflation-sensitive equity sectors over the last month is that they've done what they've done even as market expectations for rate cuts have diminished markedly. As credit markets have continued to heal and macroeconomic data has continued to come in strong, futures markets at this point aren't fully priced to reflect even a single rate cut this calendar year (see "Enough Recovery for the Fed?" October 12, 2007). As the chart on the previous page illustrates, about half of gold's $100 rally since the end of September occurred while rate cut expectations were dropping by half -- a downshift in Fed expectations that might have been expected to blunt the inflation expectations reflected in gold. It's an interesting thought experiment to consider what even greater move gold (or oil, or the dollar) might have made if rate cut expectations had stayed as elevated as they were a month ago.

Some commentators have adduced geopolitical explanations, and such things can never be ruled out. But in our view, the message from inflation-sensitive markets is that the Fed is *already* easy with a funds rate of 4.75%. And given its avowed focus on "risk-management considerations" the Fed is likely to stay easy for as far as the eye can see. At 4.75%, the funds rate may be tight with respect to the housing sector, 5% of the overall economy that is in sharp contraction. Indeed, at this point no funds rate would be easy enough for that sector. But at the same 4.75%, the funds rate is both stimulative and inflationary for the other 95% of the economy outside housing. The 4.75% funds rate is well below the nominal four-quarter growth rate of GDP ex-housing, suggesting a growth arbitrage in which one could borrow from the Fed and invest the money randomly across 95% of the economy, and earn a handsome fully levered return. That arbitrage is the fundamental carry trade by which central banks stimulate investment and get new money into circulation. That carry trade is likely to be on the table for what the Fed used to call "a considerable period" -- until the Fed somehow assures itself that the worst of the housing slump and mortgage crisis have passed, or until overwhelmingly persuasive evidence of inflation make the Fed's "risk management considerations" too expensive. During that "considerable period," if growth surprises on the upside -- as we think it will -- then the 4.75% funds rate implicitly gets easier and easier.



BOTTOM LINE: Even without further rate cuts the Fed is easy, and will likely be easy for a long time. That's good for growth in the short run, and bad for inflation in the long run. Commodities, and the equity sectors linked to them, are the dual beneficiaries of growth and inflation. Energy

is now the best-performing sector since the July top, and energy and materials are by far the best performers since the August bottom. A brief speculative correction is likely in store soon, but with growth intact and the Fed committed to easy money as far as the eye can see, these inflation-sensitive sectors should continue to be the best performers. For stocks overall, a scare over high oil prices may well trigger a reaction soon, but with the Fed easy and growth intact, we expect it will be only a brief correction.