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The Dollar Will Have to Wait

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The cost of too much ease is becoming clearer to Bernanke, but it won't turn off his liquidity fire-hose.

We definitely missed a turn. Our expectation two weeks ago that stocks would stabilize was wrong (see "Financials Stink Up the Joint" October 25, 2007). And our judgment that pessimism about the financial sector was overdone now seems overwhelmed by far greater pessimism -- as write-downs from major banks are treated by the market as harbingers of more write-downs to come. Ironically, one element critically weighing on stocks here has to do with a call that we got exactly right. In the morning before the Fed cuts rates on September 18, we wrote that any surprise in the direction of ease would unleash a new wave of inflation expectations and dollar weakness (see "A Dearth of a Thousand Cuts" September 18, 2007). With gold then at about $715, we said "gold will be at $1000 before you know it" -- and now we're well on our way.

Update to strategic view
US STOCKS: Deepening panic in the financial sector, with fears of a run on the dollar constraining the Fed's willingness to keep liquefying the banking system, have infected stocks overall. Yet the Fed continues to inject liquidity, even beyond the banking system's apparent immediate needs. At today's prices and considering today's low Treasury yields, the equity risk premium is about as generous as at any time in almost a quarter century. We think stocks are looking for a bottom not far from here, and are poised to rally considerably on the least good news.
[see Investment Strategy Dashboard]

A potentially runaway inflation dynamic is becoming a constraint on what the Fed can do to meet Wall Street's demands for ever more liquidity to assuage the mortgage-driven credit crisis (see "From Line in the Sand, to Sand in the Face" October 30, 2007). In the same crisis atmosphere that makes it incumbent upon the Fed to keep easing, it's not difficult to imagine that easing turning the decline of the dollar turning into a genuine run, or moving crude oil to prices that would start having serious impact on US consumption. Ben Bernanke all but admitted as much in his congressional testimony this morning, in which he spoke in the starkest terms yet about downside risk to growth on the one hand, and upside risk to inflation on the other hand. On inflation, he moved beyond his usual talking point about short run effects of higher commodity and energy prices and a weaker dollar, and conceded that they have "the potential to boost inflation in the longer run as well" if "inflation expectations become unmoored." This puts monetary policy not so much in center of a balance of risks, but rather between a rock and a hard place. Bernanke appears to be glimpsing now what we've seen all along -- the various forms of "slack" in the economy arising from the housing downturn and the credit crisis do not

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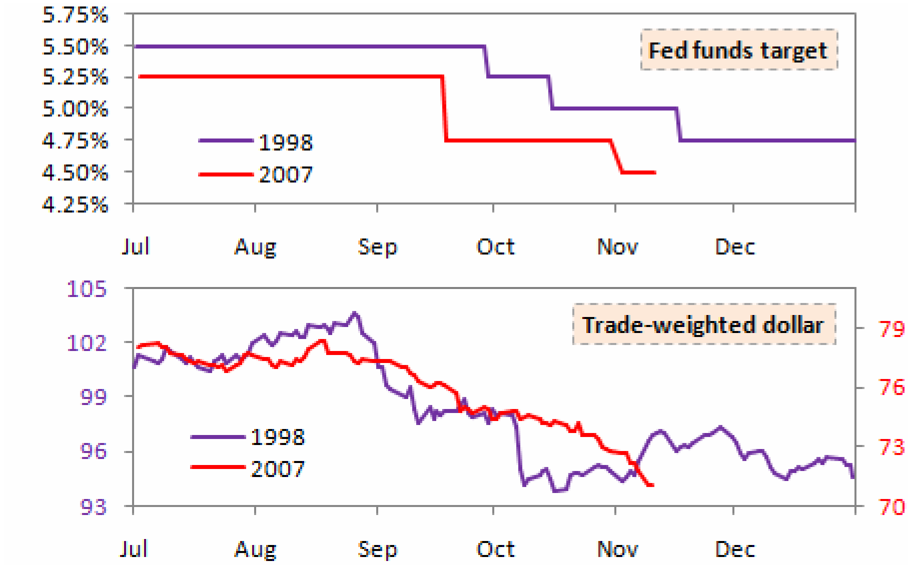
have the power to soak up the inflationary consequences of a deep and prolonged easing cycle (see, for example, "Easier and Easier" October 12, 2007).

Our prediction is that dollar weakness will just have to wait its turn for the Fed to deal with it. Ahead of it in line are the banking system and the economy. In 1998, when the Fed cut rates repeatedly to get Wall Street and the economy through the credit crisis surrounding the Russian debt default and the collapse of Long Term Capital Management, the dollar fell more in percentage terms than it has in the present crisis. That didn't stop the Greenspan Fed from cutting rates so long as the crisis persisted, and it's not likely to stop the Bernanke Fed either.



Judging from the extraordinarily large liquidity injections made this week in open market operations, even though the funds rate has been trading *below* the Fed's target, it would seem that the Fed is easing even more than the banking system wants or needs right now (see "Fed Liquidity Runneth Over" November 7, 2007). But the Fed must have *something* in mind. Part of it is a desire to inspire confidence -- and Wall Street is hungry for that. As this report is being written, stocks have stabilized from their free fall -- it remains to be seen for how long -- just as expectations in the Fed funds futures markets moved to full certainly that there will be another rate cut at the December FOMC meeting. To be sure, no amount of liquidity is going to spare those who made poor investments in subprime mortgages from having to take their losses, and those losses are the focus of investor anxiety right now. But the abundant -- indeed, overabundant -- liquidity being supplied by the Fed can deal with the risk that banks who bear large losses will become catastrophically undercapitalized, needing to shrink their balance sheets on fire-sale terms and left unable to meet the borrowing needs of customers. Fed-created liquidity ensures that the banking system can quickly restructure and recapitalize -- and while that's a painful prospect, consider the alternative of having to do it in the tight money environment of the Volcker/Greenspan years, rather than in Bernanke's world of all-you-can-eat liquidity on demand.

BOTTOM LINE: Deepening panic in the financial sector, with fears of a run on the dollar constraining the Fed's willingness to keep liquefying the banking system, have infected stocks overall. Yet the Fed continues to inject liquidity, even beyond the banking system's apparent immediate needs. At today's prices and considering today's low Treasury yields, the equity risk premium is about as generous as at any time in almost a quarter century. We think stocks are looking for a bottom not far from here, and are poised to rally considerably on the least good news.