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MARKET CALLS

The Other Winners in the Credit Crisis

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If you didn't short risky credits, being long inflation has been the place to be.

Obviously the highest-profile plays in the credit crisis were all about shorting risky credits and seeking safe haven in Treasuries. From mid-year 2007 before the crisis struck, investors able to do exotics could have gained 78.0% by shorting the ABX BBB - 6/2 CDO index, and more plain vanilla shorts could have earned 25.0% betting against the S&P 500 financial sector. Plain vanilla longs could have earned a total return of 11.1% by owning the JP Morgan 10-year+ Treasury Index.

But there was another way to play the credit crisis, too: by betting on the inflationary consequences of the Federal Reserve's reaction to it. When the credit crisis hit, we predicted that the inflation pressures we'd already been tracking for several years would sharply accelerate (see "Thoughts After a Very Rough Week" July 30, 2007). In virtually every possible way -- commodity prices, equity sector performance, foreign exchange, Treasury spreads, and even lagging official statistical measures -- they have. Let's look at the scoreboard.

- Gold is up 39.1% since mid-year, and crude oil is up 35.6%. There's pretty much no other investment you could have made on the long side since the onset of the credit crisis that would have produced anywhere near such gains. Even investing in speculative Chinese equities would have gotten you only about half-way there (and about a quarter of *that* was due to dollar weakness).

- Since mid-year, energy has been the best-performing S&P 500 sector, with a positive total return of 4.9% while the S&P 500's total return was a loss of 9.1%. Thus *the energy sector has outperformed the broad market by about the same amount that the financial sector has underperformed it.* Basic materials has been the second best-performing S&P 500 sector, with a positive

Update to strategic view

US MACRO: The Fed's most dramatic inflationary responses to the credit crisis may be behind us. But as long as the market turbulence lingers, it will be a Sword of Damocles over the Fed, keeping policy loose and inflationary.

US RESOURCE STOCKS, COMMODITIES, GOLD, OIL: Growth surprises are likely to all be on the upside, given universally negative sentiment, but monetary policy is likely to stay loose and inflationary as long as the credit crisis lingers. Better than expected growth and continuing inflation pressures make a two-pronged case for staying in the inflation plays, which have both cyclical and monetary drivers.

US DOLLAR: Continuing loose monetary policy from the Fed will be a force for dollar weakness, but increasingly other central banks may match the Fed's posture, which will create the illusion of stability in dollar foreign exchange rates.

[see Investment Strategy Dashboard]

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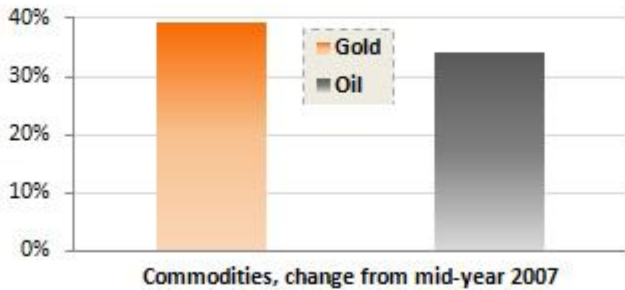
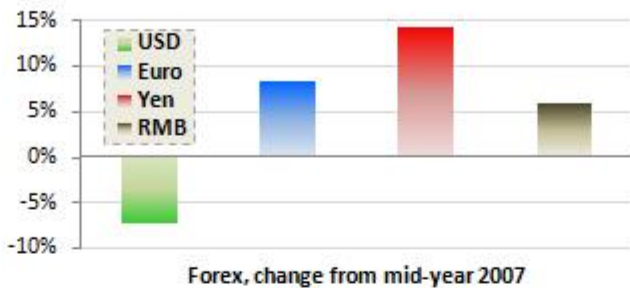
total return of 1.8%. Both sectors have been highly volatile, and for that matter there is a case to be made that stocks should been avoided entirely during the credit crisis. But for many equity-mandate investors, that's not a feasible alternative -- for them, the two US resource sectors have been the best place to be.





- The trade-weighted dollar is off 7.3%, with the euro up 8.4%, the yen up 14.2%, and the RMB up 6.0%. For investors who hedged their dollar exposure in forex markets, this has produced substantial gains (best trade: long gold hedged to yen). But investors who, instead, avoided the dollar by selling US stocks and buying foreign stocks generally came out losers. In developed markets such as Europe and Japan, local currency stock returns were far worse than those of US stocks, entirely overcoming the currency advantage.

- The 2-yr/10-yr Treasury spread has widened from 16 bp at mid-year to 185 bp now, reflecting rising inflation fears in tandem with increasing expectations for Fed rate cuts (see . There are many different ways to have played this steepening, producing very different magnitudes of gains depending on exactly how they were structured. But within the context of such plays, this has been a near-historic winner. A curve steepening of this magnitude and with this rapidity is a four standard deviation move, and has been matched only twice before in history (in mid-1980 and in early 1982).

Aside from these investible inflation plays, even lagging official statistical inflation measures have kicked up since mid-year. The Consumer Price Index has risen from a 2.7% annual rate at mid-year to a 4.1% rate now; the core index has risen from 2.2% to 2.4%. Personal Consumption Expenditure inflation has risen from a 2.3% annual rate to 3.5%, with core rising from 1.9% to 2.2% (that is, it has move from below the upper band of the Fed's "comfort zone" to above it).

Also, the 5-year forward TIPS breakeven spread has risen from 2.4% at mid-year to 2.7% now. We have never put much reliance on TIPS as inflation predictors, but we know that Ben Bernanke watches them to determine if inflation expectations are "well anchored." We also know that he pays particularly attention the 5-year forward spread, which is now sending a very different signal than either of its two components (the 5-year spread and the 10-year spread). The levels of the components, separately, appear generally quiescent -- the 5-year spread is at 2.0%, and the 10-year is at 2.3%. But the forward rate derived from them suggests that this apparent quiescence is masking what amount to "back-end loaded" inflation expectations. *All* these spreads seem out of whack to us, with CPI currently running at 4.1% year-over-year. But

one who willing to rely on TIPS at all could infer that the 5-year forward spread is saying that inflation is likely to stay contained in the near term, but then will rise in the long term.

Where do we go from here?

There's a case to be made that the biggest increment in inflation pressure has already occurred, with the Fed's move from a funds rate 5.25% to 3%. What are the odds that there will be another rogue trader who will destabilize global markets and fool the Fed a second time into cutting rates 1.25% within a two week period (see "Jump! How High? Cut! How Low?" January 31, 2008)? Pretty low, but then again the credit crisis has shown a seemingly inexhaustible imagination in coming up with new hot-spots requiring lower and lower interest rates from the Fed. Today futures markets are calling for more than another 100 bp in Fed rate cuts -- and if history is any guide, not only will the Fed not dare disappoint these expectations, but as soon as it fulfills them they will become even greater (see "Waiting Game" February 15, 2008). So we can't rule out a move in expectations to, say, a 1% funds rate -- nor rule out that the Fed will accommodate those expectations. And 1%, which the Fed sees as the operation equivalent of zero, is not a necessary ending point for easing. As Ben Bernanke taught in his notorious "helicopter drop" speech in November 2002, a Fed stuck at 1% can ease further by promising to maintain that low rate for a "considerable period," or by intervening in markets for long-term Treasuries or mortgage-backed securities.

So we mustn't necessarily assume that the Fed is closer to the end than the beginning of this easing cycle, or that there is no room for more surprises in the direction of greater inflation pressure. And we must remember that, even before this cycle began, the Fed was not tight. At the very peak at mid-year 2007, the real funds rate (the nominal funds rate minus core PCE inflation year-over-year) reached only 3.3%. That's slightly higher than the average of 2.5%, but not tight. Over the last 40 years, every recession has been preceded by a peak in the real funds rate -- and the lowest peak on record was 4.4%, more than 1% higher than the peak in the last rate-hiking cycle. Now, with the nominal funds rate at 3% and core PCE inflation at 2.2%, the real funds rate is only 0.8%. At the next FOMC meeting the Fed is sure to cut rates again by at least 50 bp, and core PCE will probably move up, too -- so within a matter of weeks, the real funds rate could be zero. If the futures markets are right, several weeks later it will be negative.

At the same time, we think that the economy is only in a sentiment-induced soft-spot rather than tipping into a fundamentals-driven recession (see "Soft Spot, Not Armageddon" January 17, 2008). And we think that while sentiment is so bleak that macro data surprises virtually have to be on the upside (see "Don't Be Surprised If Data Surprises" January 28, 2008), that sentiment is likely to exaggerate negative evidence and depreciate positive evidence. So continued easing by the Fed will be increasingly superfluous and increasingly inflationary (and even potentially counterproductive -- again, see "Waiting Game"). Yes, surely both the credit crisis and the soft-spot have been ameliorated in various ways by the Fed's provision of liquidity in the present rate-cutting cycle, but the Fed's tools are imprecise at directing liquidity only where it is needed, and not where it is not needed. If the Fed's easing during the crisis had been sufficient only for its intended purposes and no more, then we would not be seeing all the evidence of rising inflation and rising inflation expectations that we have enumerated here.

So while the inflation plays have already produced outstanding returns, we don't think they are yet played out. We are encouraged in this by how little we hear in the marketplace about inflation, and -- when the subject comes up at all -- how much complacency there is about it, and how many excuses there are to explain away the evidence. When inflation is better understood as an investible theme -- rather than a stealth dynamic -- then the inflation plays will complete their last big move. When inflation is eventually *fully* recognized, the Fed will have no

choice but to counteract it -- that will be the end of the inflation plays, and also a serious long-term macro risk (again, see "Jump! How High? Cut! How Low?").

BOTTOM LINE: The Fed's most dramatic inflationary responses to the credit crisis may be behind us. But as long as the market turbulence lingers, it will be a Sword of Damocles over the Fed, keeping policy loose and inflationary. Growth surprises are likely to all be on the upside, given universally negative sentiment. Better than expected growth and continuing inflation pressures make a two-pronged case for staying in the inflation plays, which have both cyclical and monetary drivers. Continuing loose monetary policy from the Fed will be a force for dollar weakness, but increasingly other central banks may match the Fed's posture, which will create the illusion of stability in dollar foreign exchange rates (see "A Stronger Dollar? Don't Be Fooled" February 12, 2008).