Trend Macrolytics, LLC
Donald Luskin, Chief Investment Officer
David Gitlitz, Chief Economist
Thomas Demas, Managing Director

MACROCOSM

Three Quarter Profile In Courage

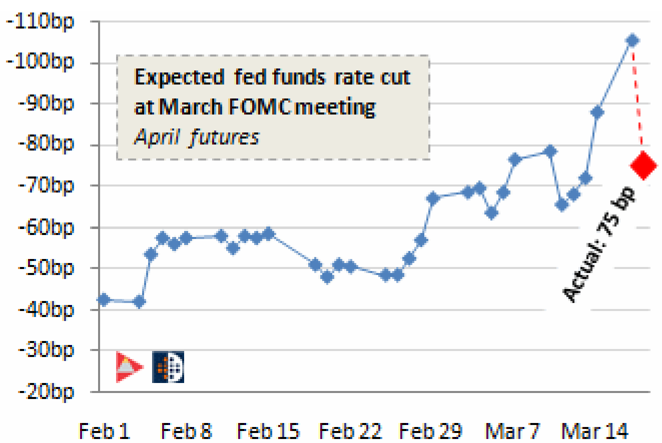
Wednesday, March 19, 2008

Donald Luskin

The Fed signals an end to endless rate cuts, and markets signal the Fed may have finally mastered the credit crisis.

Our call Monday before the opening to buy into weakness -- admittedly, made with our heart in out throat -- has been vindicated by the biggest up day for stocks in 5-1/2 years (see "Bernankruptcy" March 17, 2008). Astonishingly, it occurred on the day when, for the first time since the onset of the credit crisis -- or for that matter, the first time ever -- the Fed dared to substantially disappoint market expectations for rate cuts. Today, in the cold light of dawn, we'll see what sticks. But yesterday's 75 bp cut in the face of futures markets more than fully priced for 100 bp was a small but potentially significant and potentially very positive act of courage from an FOMC that has otherwise been a cowardly slave of market expectations (see, among others, "'Act As Expected'" November 28, 2007).

To be sure, 75 bp is still a substantial cut, and expectations for 100 bp had only been in place for two days. Further, over the weekend, the Fed had just created a whole new lending facility for distressed broker-dealers, having the previous Friday extended a $30 billion non-recourse loan to JP Morgan against Bear Stearns' illiquid mortgage-related assets. Finally, at the time the FOMC announced the 75 bp cut, markets were already celebrating the avoidance of a systemic contagion of



Update to strategic view

US STOCKS: Yesterday's extremely positive reaction to a disappointing rate cut suggests that the Fed may finally have a handle on the credit crisis, be in a position to restore its damaged credibility, and limit the inflationary costs of its past errors. This all reinforces our hope that Monday's panic will be a durable bottom for stocks, and that the enormous equity risk premium can start getting absorbed.

US RESOURCE STOCKS, COMMODITIES, GOLD, OIL, US DOLLAR: Yesterday's disappointing rate cut and the potential cessation of the credit crisis may signal the deceleration of the Fed's long-standing inflationary posture. It's too soon to be certain, but we are reverting to last week's position of caution on the "inflation plays."

[see Investment Strategy Dashboard]

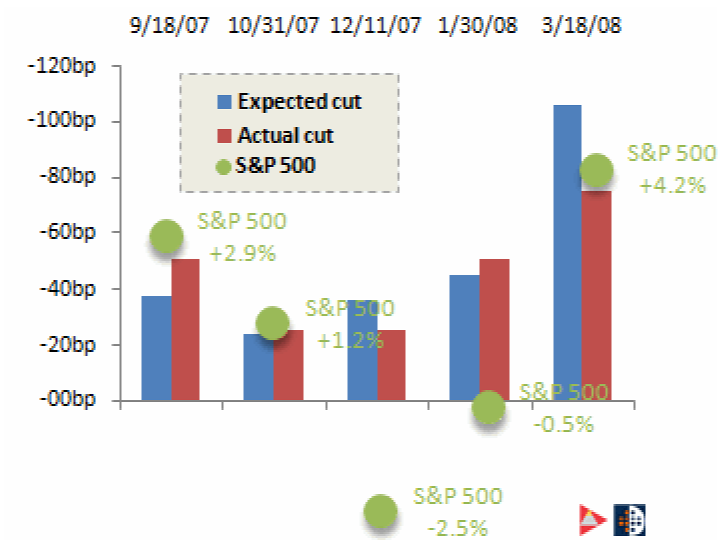
http://www.trendmacro.com
don@trendmacro.com
dgitlitz@trendmacro.com
tdemas@trendmacro.com

Offices:
Menlo Park CA
Parsippany NJ
Charlotte NC

Phone:
650 429 2112
973 335 5079
704 552 3625

bank runs that might well have followed in the wake of Bear Stearns' failure. So it's hard to really call yesterday's 75 bp tough love.

Nevertheless, we think it potentially marks a significant and very positive turning point for the Fed. Perhaps the markets are celebrating the possibility that -- finally! -- the Fed has found a new set of technical tools for effectively dealing with the credit crisis, suggesting that the worst may now be over (see "On the Term Securities Lending Facility" March 11, 2008, and "On TAF and Jobs" March 7, 2008). Perhaps -- finally! -- the Fed can now work toward restoring its damaged credibility by no longer making ludicrous denials of the rising threat of inflation and dollar weakness (see "Well Anchored?" March 5, 2008), resulting from their excessive reliance on the blunt force tool of the funds rate to deal with the credit crisis. Perhaps -- finally! --now the Fed can begin to candidly address those realities as yesterday's FOMC statement did.



It may seem that markets would like nothing better than a Fed that will drop money from helicopters at the least sign of distress. Indeed, throughout the credit crisis, on FOMC days when the Fed has delivered rate cuts exceeding expectations, stocks have generally rallied. The one time the FOMC disappointed slightly -- by only 11 bp at the December 11, 2007, meeting -- stocks reacted with a 2.5% drop. But the moral hazard implicit in a Fed that is the slave to market expectations has now reached truly dangerous proportions -- driving the worst inflation in more than a decade, and underwriting the predatory takeover of one blue chip investment bank by another (see, again, "Bernankruptcy"). Yesterday's very positive reaction to the FOMC's "disappointment" may indicate that, ultimately markets would prefer a strong, credible and honest Fed. Only that kind of Fed has a chance of using its power and prestige to ultimately restore confidence in damaged credit markets.

One key sign that markets are recognizing -- and accepting -- a real change at the Fed is the reaction in rate expectations following yesterday's 75 bp cut. Throughout the credit crisis, whenever the Fed has cut rates, expectations reflected in futures markets have immediately deepened -- that is, the more the Fed has cut, the more the Fed has been expected to cut *again* in the future. This time, after the 75 bp cut, futures markets for the first time moved in the opposite direction -- with 22 bp, or almost one whole rate cut increment, instantly coming out of expectations for the May FOMC meeting.

The prospect that the Fed has finally licked the credit crisis, and has begun to restore its credibility, reinforces our hope that stocks have found a durable bottom. There remains a tremendous risk premium to be collected as confidence is restored. But this potentially changes the outlook -- again! -- for the "inflation plays" that have performed so well during the credit crisis: US resource stocks, gold, oil, commodities and foreign exchange. Just a week ago, when the Fed introduced the Term Securities Lending Facility, we speculated that it might prove to be a non-inflationary way of solving the credit crisis, and ending up substituting for further inflationary cuts in the funds rate (again, see "On the Term Securities Lending Facility"). Accordingly, we said, "It's too soon to say the inflation theme is over, but this is a cause for caution." Then, after Sunday's announcement of the Primary Dealer Lending Facility, and the odor of panic following the shocking sale of Bear Stearns for only $2 a share, we changed course, saying that these developments "put the inflation game into extra innings." Now we must change course again. With the FOMC's small gesture of courage, its relatively honest acknowledgement of inflation risks, and the dissent of two FOMC members -- Dallas' Fischer and Philadelphia's Plosser, both of whom preferred an even "less aggressive action" -- we must revert to a position of caution on the inflation theme.

The reaction to yesterday's rate cut by inflation-sensitive markets was instructive. Gold fell. The dollar rallied. The yield of the on-the-run 5-year TIPS went from negative to positive. Oil was the only inflation-sensitive market that rallied. At the same time, we don't know with a high degree of certainty that the Fed is really going to keep its helicopters in the hangar, especially if there is another eruption of credit market turbulence. We don't know when or how aggressively the Fed will be willing to raise rates that are already extremely low -- indeed, negative in real terms. We must recognize that the legacy of the inflation *already* created by the Fed's mistakes during the credit crisis -- and for that matter, ever since the "considerable period" of ultra-low rates in 2003 and 2004 -- has yet to fully roll through the economy and investor consciousness. And some of the "inflation plays" are growth-sensitive, and today's developments are as potentially good for growth as they are potentially bad for inflation -- in part, because limiting the extent of further inflation is itself good for growth. So it will take a little time to let things play out a bit while we collect more data and impressions before we can abandon a strategic theme that has been in place now for several years, and has delivered extraordinary investment results (see "The Other Winners in the Credit Crisis" February 19, 2008).

BOTTOM LINE: Yesterday's extremely positive reaction to a disappointing rate cut suggests that the Fed may finally have a handle on the credit crisis, be in a position to restore its damaged credibility, and limit the inflationary costs of its past errors. This all reinforces our hope that Monday's panic will be a durable bottom for stocks, and that the enormous equity risk premium can start getting absorbed. This may signal the deceleration of the Fed's long-standing inflationary posture. It's too soon to be certain, but we are reverting to last week's position of caution on the "inflation plays."