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

MACROCOSM

2 + 2 = 3 and 3 - 2 = 2

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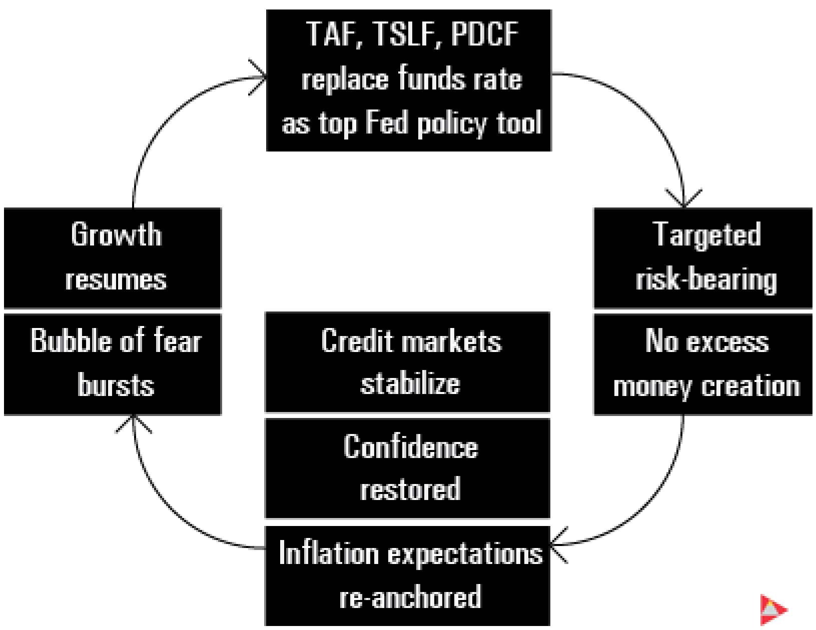
Donald Luskin

The Fed's new virtuous cycle changes the relationship of growth and inflation.

With its Term Auction, Term Securities Lending and Primary Dealer Credit Facilities, the Fed has finally found tools for dealing with the credit crisis that are both *effective and non-inflationary*. And with its new-found courage to disappoint market expectations for cuts in the funds rate, the Fed has also finally started setting aside tools that are both *ineffective and inflationary* (see "Three Quarter Profile In Courage" March 19, 2008).

Update to strategic view
US RESOURCE STOCKS, OIL, COMMODITIES: The inflation plays that are also growth plays have the best prospects within the theme, as the reduction of inflation risk itself contributes to better economic growth. **GOLD, US DOLLAR:** The inflation plays that are not also growth plays -- gold and the dollar short -- will fare the worst as inflation risk ebbs, enjoying little offset from improving growth prospects.
[see Investment Strategy Dashboard]

The Fed's having now called home the money-drop helicopters that were creating inflation pressures without doing anything to stabilize credit markets, a positive new dynamic is afoot for growth and inflation. That's why we continue to believe that the bottom is in for equities (see "Bernankruptcy" March 17, 2008). And it's why we have gone to neutral, but not to negative, on the "inflation plays" -- gold, oil, commodities, resource-driven equity sectors, and foreign currencies (see "Inflation Inflection" March 25, 2008). Many of the "inflation plays" will benefit from a revival of growth expectations even though, at the same time, they are hurt by the diminution of inflation expectations.



If we are correct about the Fed's

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

new tools, then the *vicious cycle* of counterproductive rate cuts, a deepening credit crisis, eroding confidence, rising inflation and a slowing economy -- leading to the next round of cuts, and so on *ad infinitum* -- has been arrested. In its place is a new *virtuous cycle*, in which the Fed's targeted interventions as risk-taker of last resort lead to improvements in credit conditions, rising confidence, the re-anchoring of inflation expectations and economic reacceleration. It *doesn't* mean that there won't be continued significant fallout from the credit and housing sins of the past, nor that there will be no inflationary consequences from the Fed's ill-advised rate-cutting campaign which did so little to stabilize credit markets. It *does* mean that, finally, with credit markets stabilized, the financial system can undertake the necessary tasks of restructuring and rebuilding, and that a worst-case inflation outbreak has been avoided. That would set the stage for a recovery of confidence, and the emergence from the fear-driven economic slowdown of the first quarter (see "Weak Jobs Today, Better News Ahead?" April 4, 2008).

For the inflation plays -- gold, oil, commodities, resource-driven equity sectors, and foreign currencies -- this is a mixed blessing. For the past several years, they've benefited from both strong global growth and rising US inflation -- indeed, they have been growth plays as much as inflation plays. Growth has pushed up demand ahead of supply, and inflation has pushed up nominal prices. But while those forces have worked together to move many commodity prices to all-time highs and the US dollar to all-time lows, and to make the energy and materials sectors the best performing in the S&P 500, they've also worked at cross-purposes. Inflation is ultimately corrosive of growth for many reasons, not least of which is that the Fed eventually acts to turn it back, usually triggering a recession in the process. So while inflation boosts nominal prices, at the same time it reduces demand by reducing growth expectations. For inflation and growth together, it's a case of 2+2=3, not 4.

When inflation is taken out of the picture -- or, as in the present situation, reduced from a previously expected worst-case scenario -- the inflation plays become more like simple growth plays, and a significant part of the bull case is removed. But if 2+2=3, not 4, then 3-2=2, not 1. Because when the threat of inflation and the Fed's ultimate reaction to it is reduced, growth prospects are enhanced. Inflation plays may reduce to mere growth plays, but their growth component is stronger than it was when they were both inflation plays and growth plays.

We can see this playing out in the relative behavior of various inflation plays since the Fed's new virtuous cycle fell into place after the March 17 rescue of Bear Stearns and the March 18 FOMC meeting. As of this writing, gold is off 5.8% from March 17, while crude oil is off only 0.7%. That's because gold -- a metal with little industrial use that is virtually a money substitute -- is the purest inflation play, influenced barely at all by changing growth prospects. So as inflation expectations have fallen over the last three weeks, improving growth prospects have not acted as an offset to support the gold price. Oil, on the other hand, is primarily a growth play. Its price has been supported by improving growth prospects, even as inflation expectations have fallen.

So we don't see the occasion of an improving inflation picture -- at the very least, the apparent elimination of the worst-case inflation scenario that seemed so imminent just weeks ago -- as a reason to evacuate investments in commodities or resource-driven equity sectors. We are neutral on the theme now, not negative. Our view is that the theme is not as strong now, supported only by growth as it once was supported by both growth and inflation. So while we don't see any reason to expect significant underperformance, we don't expect going forward the same kind of outperformance that we've seen in the past. Since the present bull market began in October 2002, the S&P 500 returned 82% though the March 17 bottom -- the energy and materials sectors strongly outperformed, returning 257% and 174% respectively. But since the March 17 bottom through Friday's close, the S&P 500 has returned 7.4% -- the energy sector has lagged, returning 6.5%; and the materials sector has only narrowly outperformed, returning 7.8%.

BOTTOM LINE: The inflation plays that are also growth plays have the best prospects within the theme, as the reduction of inflation risk itself contributes to better economic growth. The inflation plays that are not also growth plays -- gold and the dollar short -- will fare the worst as inflation risk ebbs, enjoying little offset from improving growth prospects.