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

MACROCOSM

Fail-Safe

Wednesday, July 2, 2008

Donald Luskin

Markets are all at critical test-points, waiting to see if the Fed will act to support the dollar and stabilize the oil price.

Last week we wrote that "a durable bottom can't come now until Bernanke signals he will act decisively to normalize rates in order to stabilize the dollar and oil. If he doesn't do so soon, then all bets are off" (see "Markets Speak, Bernanke Needs to Act" June 27, 2008). We're still waiting. And while we wait, oil makes new highs, the S&P 500 and the trade-weighted dollar flirt with their March lows, and gold tests the top of its post-March trading range. These markets are holding -- barely -- at their "fail-safe points," levels beyond which the implications for growth and inflation are very serious. Once again the scent of panic is in the air -- in part, we suspect, because once again there is a scent of panic emanating from the Fed. A confident, credible Fed that makes sensible commitments and follows through on them is always of great importance to markets, but now more so than ever. At this particular moment, when the consensus has become obsessed with the risk of global inflation -- especially as expressed in the increasingly growth-threatening oil price -- the Fed and only the Fed has the power to restore confidence.

Update to strategic view
US STOCKS: So far stocks have resisted making new lows, especially if the financial sector is removed from the calculation. The equity risk premium has become enormous, so even a breach of the lows may not imply a significant follow-through lower. The sensible thing to do is to buy weakness. But that said, we are increasingly alarmed by the Fed's failure to reassure markets that it intends to support the dollar and, implicitly, stabilize the oil price. If that evolves into an evident policy of accommodating the oil price spike, then all bets are off.
[see Investment Strategy Dashboard]

One month ago it seemed Ben Bernanke was well on the way to doing just that (see "The Bernanke Awakening" June 5, 2008). We were encouraged to hear him take responsibility for stabilizing the dollar -- and implicitly, by extension, the oil price -- when he said in a speech,

> We are attentive to the implications of changes in the value of the dollar for inflation and inflation expectations and will continue to formulate policy to guard against risks to both parts of our dual mandate, including the risk of an erosion in longer-term inflation expectations.

In the month since Bernanke's spoke those words, the rising oil price had become associated in the public mind with the notion of a "dollar panic." Since then, crude is 13.5% higher and the

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

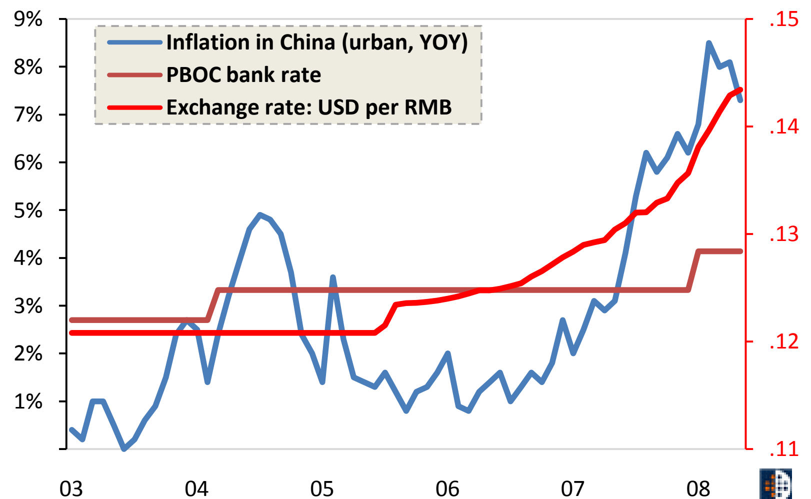
Copyright 2008 Trend Macrolytics LLC. All rights reserved. This document is not to be forwarded to individuals or organizations not authorized by Trend Macrolytics LLC to receive it. For information purposes only; not to be deemed to be recommendations for buying or selling specific securities or to constitute personalized investment advice. Derived from sources deemed to be reliable, but no warranty is made as to accuracy.

trade-weighted dollar is 1.6% lower. That's because all the Fed has done to support the dollar is to *undermine* it, by urging high-growth emerging economies to revalue their currencies. And all the Fed has done to stabilize the oil price is to urge those same emerging economies slow their growth to reduce their demand for oil. Fed vice-chair Donald Kohn said in a speech last week,

> … in those countries where strong commodity demands are associated with rapid growth in aggregate demand that outstrips potential supply, actions to contain inflation by restraining aggregate demand would contribute to global price stability. …These benefits could be increased if exchange rate flexibility were to become more widespread…

A few hours ago, stocks fell from their best levels of the day and oil surged when Fed governor Frederic Mishkin gave a speech in which he made much the same case. But on Monday, Malcolm Knight, the general manager of the Bank for International Settlements -- often called "the central bank for central banks" -- put an even finer point on it in a speech:

> The need to tighten monetary policy is particularly pressing in those emerging markets where growth is still high and real policy rates are unsustainably low. For such a tightening to have the intended effect, and with policy rates low in some key advanced industrial countries, exchange rates must be allowed to appreciate further.



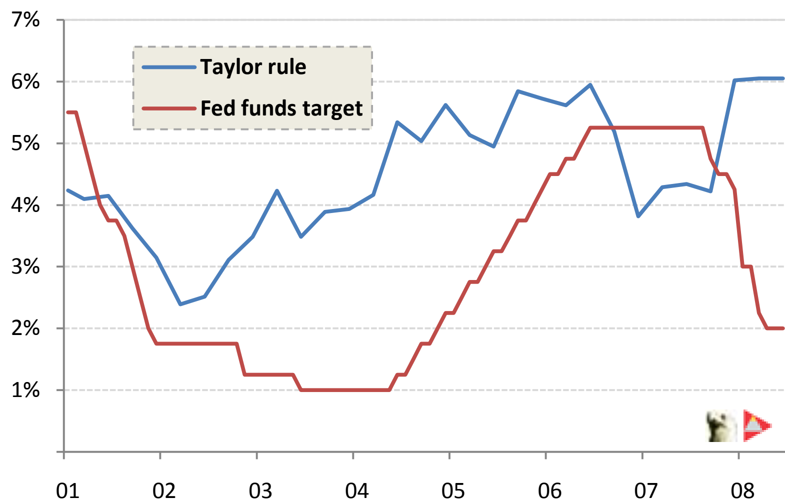
Never mind that all this smacks of beggar-thy-neighbor mercantilism, as though emerging economies ought to cripple themselves in order to lower the oil price for the developed economies. Even abstracting from the morality of it, as a pragmatic program it simply isn't going to work. For example, China's central bank has already raised its policy rate to a level more than twice the current fed funds rate, higher even that the European Central Bank's policy rate -- and it has appreciated the yuan versus the dollar considerably, almost 11% in just the last 12 months. And Chinese authorities have imposed all manner of credit controls and restrictions. For all that -- even though they've done everything that Kohn, Mishkin and Knight have prescribed -- the crude oil price is at all-time highs, and the Chinese inflation rate has risen from near zero two years ago to above 7% today.

Why? Surely not because China has failed to tighten policy, any more that Europe has failed to keep policy tight while its own inflation rate has risen dramatically, too. Both are because the dollar, as the world's reserve currency, and the currency used to price globally traded commodities such as oil, is transmitting US inflation to the rest of the world. As the institution that is responsible for the number of dollars in the world, only the Fed can deal with this problem.

Ben Bernanke knows this, or at least he once did. In three speeches he has referred to a 2001 paper by Barsky and Kilian explaining the stagflation of the 1970s not as the function of an exogenous oil price shock, but as the function of excessively accommodative monetary policy

that triggered the rise in the oil price to begin with. In two speeches in February and March 2003 Bernanke called the paper "important," and in a third speech in February 2004 he called it "influential." But there are no atheists in foxholes. From the Fed's foxhole, having to deal simultaneously with record oil prices, the falling dollar, rising inflation expectations, the sluggish economy, and continuing aftershocks of the housing bust and the credit crisis, the Fed is reverting to the old-time religion of the Phillips curve -- the idea that the Fed is a disinterested micromanager of the economic trade-off between exogenous forces of growth and inflation. As Kohn, the most devoted Phillips curve devotee on the Fed Board of Governors, put it in a speech three weeks ago,

> By pursuing actions that balance the deleterious effects of oil prices on both employment and inflation over the near term, policymakers are, in essence, attempting to find their preferred point on the activity/inflation variance-tradeoff curve introduced by John Taylor 30 years ago.



Even in *this* context, the Fed's current policy posture is not justifiable. At 2%, the funds rate is as far below the prescription given by the "Taylor rule" to which Kohn refers -- a baseline for the funds rate taking into account the trade-off between growth and inflation -- than it was in 2003 and 2004 when it was at 1%. That period, and the Fed's tardiness in normalize rates afterward, was surely what sowed the seeds for today's inflation outbreak (and the lending abuses that triggered the credit crisis). This tells us, quite simply, that the funds rate is currently far too low -- it is not high enough to stop inflation pressures from worsening, and at the same time it is lower than necessary to deal with the growth risks the the economy faces.

So long as the Fed continues to oscillate between statements of apparent vigilience -- like Bernanke's a month ago -- and of apparent irresponsibility -- like Kohn's last week, markets will continue to be driven by fear. As alarmed as we are by the Fed's dangerous indecision, we still think that better than expected macro data (such as yesterday's ISM and this morning's factory orders) and worse than expected inflation data (such as the present move by oil to new all-time highs), and the markets' evident mood of panic will drag the Fed, kicking and screaming if need be, to do something resembling the right thing.

BOTTOM LINE: So far stocks have resisted making new lows, especially if the financial sector is removed from the calculation. The equity risk premium has become enormous, so even a breach of the lows may not imply a significant follow-through lower. The sensible thing to do is to buy weakness. But that said, we are increasingly alarmed by the Fed's failure to reassure markets that it intends to support the dollar and, implicitly, stabilize the oil price. If that evolves into an evident policy of accommodating the oil price spike, then all bets are off.