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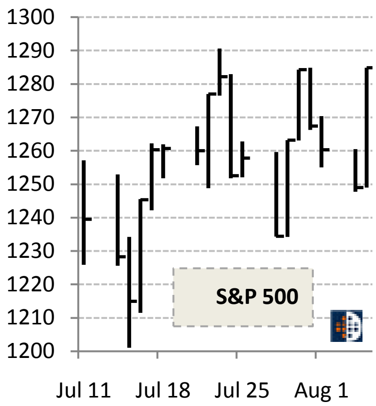
MACROCOSM

No Get Out of Inflation Free Card

Wednesday, August 6, 2008
Donald Luskin

Inflation-sensitive markets have been distracted by oil -- soon they'll turn to the Fed.

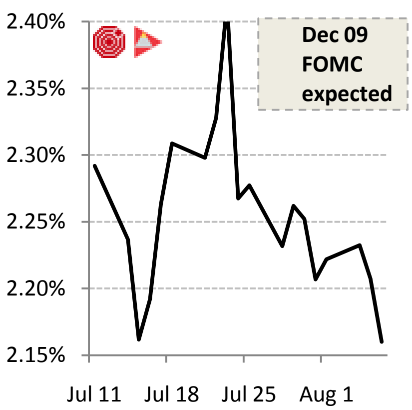


Update to strategic view

US STOCKS: It's painful, but the deeply undervalued equity market is working higher as forward earnings surge, recession or no recession.
US RESOURCE STOCKS, GOLD, COMMODITIES, OIL, US DOLLAR: The inflation plays have gotten battered as the oil bubble has burst. There's still plenty of room underneath for oil. But the sympathy reaction in other inflation plays should give way to a renewed focus on the Fed's flagrantly inflationary posture.

[see Investment Strategy Dashboard]

With yesterday's big upside move, equities have attained their best levels since the depths of the Fannie/Freddie crisis. Since the low watermark on July 15, the S&P 500 is up 7%. And it's now 2.2% above the lows set in March in the Bear Stearns crisis. It's been a rough ride, but our repeated call to buy weakness as stocks made new lows has been right (see, first, "From Correction to Test to Bear Market" July 10, 2008). Our near-term thesis for equities remains in place. The economy is sluggish to be sure, but not in recession. S&P 500 forward earnings are soaring, standing virtually at all-time highs if the financial sector is excluded (with five of the nine other sectors at, or virtually at, all-time highs). Relative to Treasury yields, the equity risk premium is as rich as at any time since 1981. And we believe that the Fed and the Treasury are both willing and able to operate effective backstops against widespread financial systemic risk (see, most recently, "Will the GSE Rescue Work?" July 14, 2008).



In the context of this view, the FOMC's decision yesterday to hold the funds rate at 2% -- and to publish a statement giving markets no reason to expect a move up to more normal rates anytime soon -- is perverse. After the FOMC's decision was announced yesterday, the fed funds futures market reduced its already low expectations for upcoming rate hikes -- the probability of even a single 25 bp hike by December fell from

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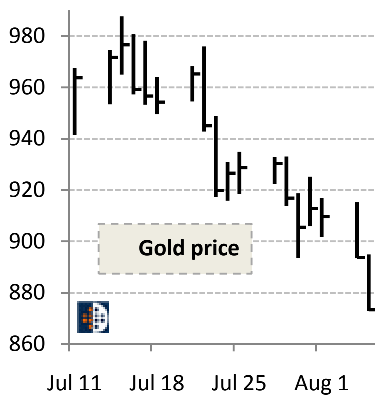
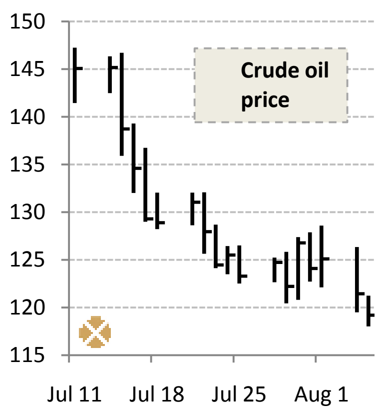
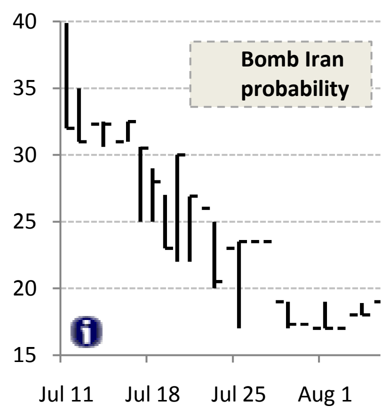
95% to 81%. This morning, they've fallen to just 63%. Expectations for a December hike are now as low as they've been at any time since the July 15 Fannie/Freddie crisis low. With the stock market up 7% since then, the crisis has passed -- so the Fed should be turning toward moving rates back up to normal levels that will quell mounting inflation pressures here and abroad (see "What Did They Do To Deserve This?" August 5, 2008).

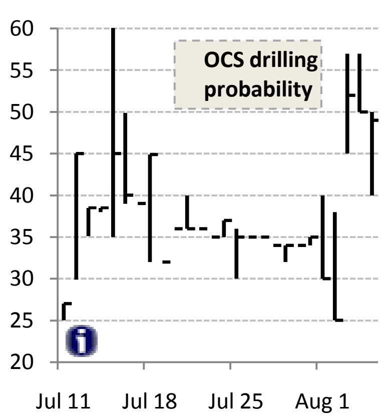


Even more perverse is the way inflation-sensitive markets have reacted to the Fed's increasingly inflationary posture since the Fannie/Freddie crisis. Even as that crisis has apparently pinned the Fed at a too-low funds rate of 2% -- which ought to substantially aggravate an already explosive inflation environment -- inflation-sensitive markets have all signaled a *lessening* of inflation expectations. Most prominently, oil has fallen from \$147 to \$118. Gold has fallen from \$988 to \$872. And the US dollar has strengthened on forex markets; for example, the euro has fallen from \$1.59 to \$1.54. This is all quite frustrating to us, as we sounded the inflation alert at the depths of the Fannie/Freddie crisis, just before all this happened -- we were right about how the Fed would react to the crisis, but so far we've been very wrong about how inflation-sensitive markets would react to the Fed (see "Stocks are Cheap, But the Fed's Asleep" July 15, 2008). We're kicking ourselves, because this blemishes our track record of having called for years every twist and turn in the inflation-sensitive markets with nearly pinpoint accuracy. And we're scratching our heads, because it really doesn't make sense.



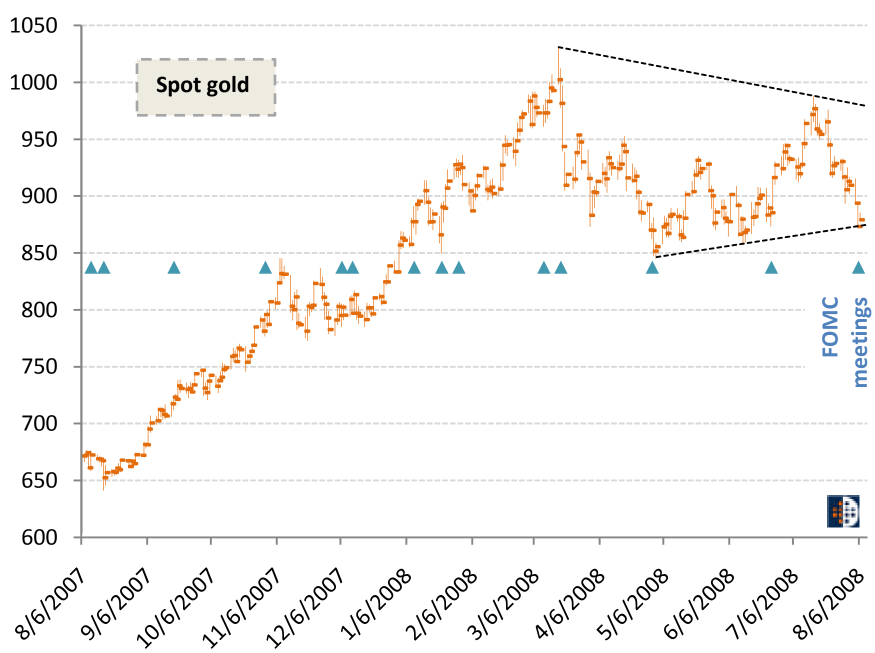


We don't give much credence to the idea that the inflation-sensitive markets have all dropped over the last three weeks because of the imminence of a global slowdown. We've heard that explanation repeatedly, especially with respect to the sharp drop in oil prices. But according to the convention wisdom, there's been an imminent global slowdown for years, including the period since March when the oil price surged. It can't explain both rising oil and falling oil. Yet oil may be the key to understanding what's happening here. Its surge to new highs from April to July was not accompanied by comparable moves in other inflation-sensitive markets -- for example, gold didn't make new highs, and the dollar didn't make new lows. We have noted all along that the rise of oil seems to have been motivated, instead, by elements of supply/demand expectations, speculation, and hedging against geopolitical risk (see "There Will Not Be Blood" April 24, 2008). The *fall* in the oil price may not have much to do with inflation-sensitivity, either. The 20% oil price drop over the last three weeks has corresponded perfectly to a dramatic decrease in tensions between the US and Iran. The Intrade online political futures contracts on a US/Israel strike against Iran by year-end have fallen from a price in mid-July indicating a 40% probability,



to a price now indicating only a 19% probability. Another relevant political development has occurred at the same time. Oil fell from all-time highs in mid-July on the day of the emergence of a bipartisan group of senators calling themselves the "gang of ten," supporting opening the outer continental shelf to offshore exploration and drilling. That day the Intrade futures contracts on legislation permitting OCS drilling by year-end traded at prices reflecting a probability of as much as 60%, and then subsequently backed off as political resistance seemed to become insurmountable. In the last several days, as Barack Obama has signaled a willingness to consider permitting drilling, the contracts have jumped to prices reflecting a probability of as much as 55% and the oil price has broken to new lows.

For these non-inflation reasons, we think, the energy complex has gotten clobbered far worse than any other inflation-sensitive market the last few weeks. It was with this kind of possibility in mind that, when we sounded the inflation alert in mid-July, we cautioned to take care with oil and with energy-related stocks because they had experienced a large run-up during a period of otherwise quiescent inflation expectations (again, see "Stocks are Cheap, But the Fed's Asleep"). That, at least, was the right call. Where we erred was in failing to appreciate the extent to which the dramatic drop in oil would trigger drops in other markets associated in the public mind with oil -- inflation plays, weak dollar plays, safe-haven plays, and so on. We've never bought into the idea that the rise of the oil price was entirely a speculative phenomenon (see, for example, "Commodity Prices: Blame the Indexers?" May 28, 2008). But all markets are subject to speculative dynamics, especially when they make highly publicized all-time highs. For the oil surge to collapse as dramatically as it has in the face of news catalysts, and to drag various allied markets along with it, is par for the course.



We'd like to believe that the drop in the last three weeks in inflation-sensitive markets is telling us that inflation risk is falling -- even as the Fed commits itself ever more deeply to a policy course that would seem, on the face of it and by all evidence, to *already* have been highly inflationary. Believe us when we say there is almost nothing we'd rather be wrong about than our concern that a worst-case inflation scenario is being put back on the table. But even if we grant that the drop in inflation-sensitive markets is telling us something good about inflation, it isn't telling us much. As dramatic as the fall in the oil price has been, it has only erased three months of gains -- for all practical purposes, at 118 it is still at all-time highs. And the gold price -- the inflation-sensitive market we watch most carefully -- is, at the most optimistic, still in an indecision pattern (see "Indecision and Inflation" July 22, 2008). While we wait for that indecision pattern to resolve, our assumption going in is that the seemingly happy signals we've been getting from inflation-sensitive markets are likely to soon be reversed -- unless the Fed miraculously reverses course in its march toward a significant inflationary error.

BOTTOM LINE: It's painful, but the deeply undervalued equity market is working higher as forward earnings surge, recession or no recession. The inflation plays have gotten battered as the oil bubble has burst. There's still plenty of room underneath for oil. But the sympathy reaction in other inflation plays should give way to a renewed focus on the Fed's flagrantly inflationary posture.