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MACROCOSM

A Deflationary Correction

Thursday, July 9, 2009

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The Fed may be off deflation watch, but markets evidently are not.

Update to strategic view
US STOCKS, US RESOURCE STOCKS, US BONDS, GOLD, COMMODITIES, OIL: We are working through the expected correction of the recovery from the March lows, with a distinct deflationary flavor owing to the Fed's having apparently gone off deflation-watch. The more markets revert to their deflationary patterns of late last year, the more likely that the Fed will be ultimately roused to reflate, as it did then. We think the correction is not over yet, but we are on the lookout for the next inflection point to buy stocks and inflation-sensitive assets, and sell Treasury bonds.
[see Investment Strategy Dashboard]

This morning's continued drop in initial jobless claims and Alcoa's encouraging earnings last night make a welcome counterpoint to the growing pessimism of the last several weeks, but will they be a turning point? We doubt it. For the last month, in every particular -- stocks down, gold down, oil down, dollar up, Treasuries up, volatility up, credit spreads wider -- it all has the odor of *deflation* about it. It's just like last October and November, but on a smaller scale, when deflation was an outright stench. Stocks are off 7% since their recovery highs when we said it was "time to trade this 'tradable rally'" (see "The Case for Ambivalence" June 12, 2009), while last year 7% drops happened in a single day. And gold is still above $900, while in the intense deflation late last year it fell below $700. But the message is clear. Ever since the Fed started to signal last

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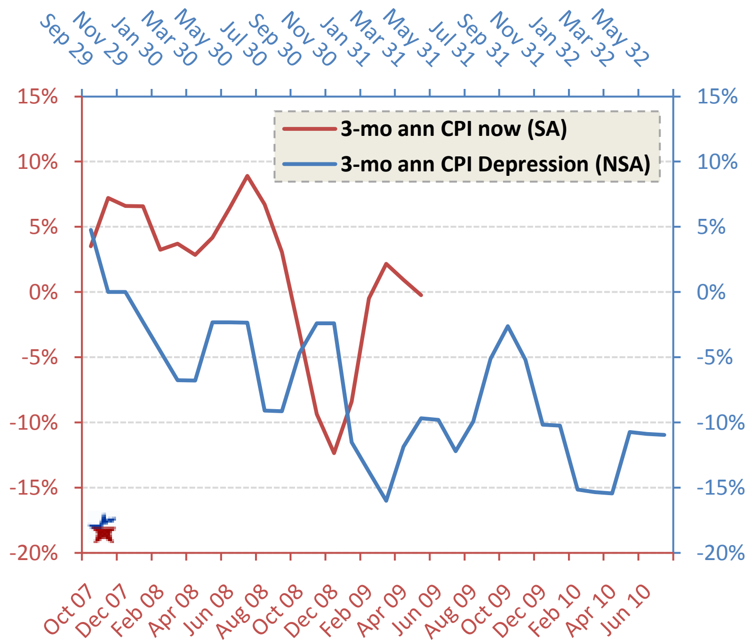
month that it was no longer worried about deflation (see first, "They Laughed When I Sat Down to Monetize" June 4, 2009), markets have been sending the message that it's too soon to declare "mission accomplished." And because avoiding deflation is a *sine qua non* of recovery, even a small probability of it deserves respectful concern.

As clients know well, our long-term concern is *inflation*, not deflation. As a baseline scenario, the Fed's likely to maintain a too-easy inflationary posture as the economy struggles through a sluggish and jobless recovery (see "The Square Root of Recovery" July 2, 2009). Even if in the meantime the Fed is faced with clear evidence of a recurrence of deflation, that will ultimately be only a painful detour on the way to inflation -- the Fed's response will surely be to inflate, as it did last year. But though we say "surely," that's just our deeply held expectation, not a certainty. What's certain is that the Fed is capable of making a mistake. It *always* is, and in fact it *usually does.* So markets are right to not take deflation risk out of their probabilistic appraisal of the future.



At the moment, it seems it was a mistake to remove from the statement following the last FOMC meeting any explicit mention of concern about deflation, only six months after the economy experienced levels of deflation similar to the worst in the Great Depression (see "Can Inflation Plays Do Without Deflation?" June 25, 2009). Yes, the Fed's extraordinary reflationary actions reversed that terrible risk (see "Ben Boldly Goes" March 19, 2009), but there's no certainty that it is a permanent fix -- in fact, on a 3-month annualized basis, the Consumer Price Index is currently registering a small amount of deflation. Last year's intense deflation was the result of a spasm of risk aversion, triggered by the global banking crisis, which dramatically increased the demand for dollars. While the banking crisis seems to be largely solved, risk aversion is still quite elevated by normal standards, and ongoing doubts about the shape of economic recovery could cause it to stay elevated or become more so. And with such intense deflation having been experienced so recently, *deflation is itself a risk to which markets are very understandably averse, the elevation of which could trigger another surge of deflationary money demand* -- and thus set in motion a vicious cycle similar to the one visualized by Irving Fisher in his famed 1933 analysis, "The Debt-Deflation Theory of Great Depressions." We're not predicting that -- we're saying it's a risk, and that markets have to take it into account until it's ruled out.

With the Fed well aware of the dangerous dynamics of deflation, we expected it to hew to a risk-management model that willingly induced inflation to head off even the risk of deflation (see "Too Soon to Stray" June 23, 2009). Such a risk-management approach is always appropriate under uncertainty. As Ben Bernanke once said, "it is rarely the case in economics that the optimal amount of insurance in any situation is zero." The Fed's seeming willingness to do without such an insurance policy against deflation -- or at least, by silence about it, to leave the markets wondering -- is quite unwise, and may induce the very problem that it may think it has solved.

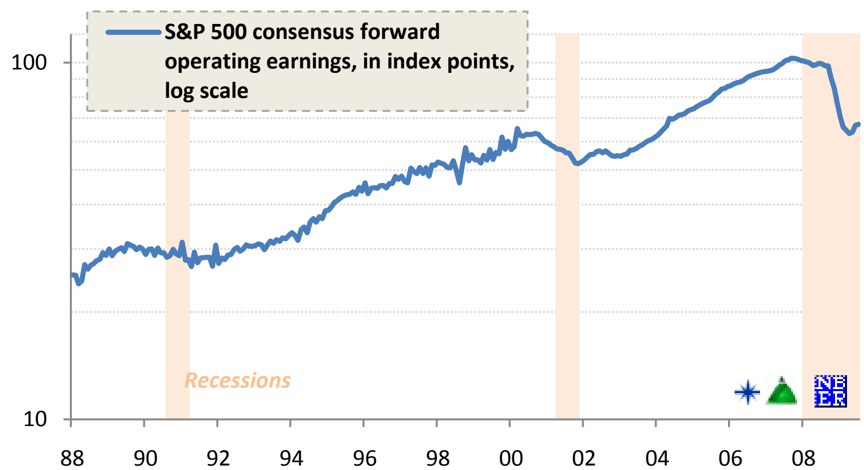
If the Fed *usually makes mistakes*, it's certainly no surprise that it would make one now -- with the economy and the banking system under stress, and with markets sending so many conflicting signals. For example, what is the Fed to make of the action in 10-year Treasuries? Just a few weeks ago it seemed no one wanted the 10-year when its yield was 4%, while yesterday's auction at 3.36% was reportedly on "the biggest demand for a 10-year note auction since at least 1995." The Fed resisted pressure to intervene by buying more bonds when yields were 4%, claiming this was evidence of markets returning to normal levels of risk tolerance -- though it surely must have feared that the yield back-up would make economic recovery more difficult (see "No, Mr. Bond, I Expect You to Die" May 22, 2009). In one sense the Fed got its wish -- yields are much lower now, and present a lower barrier to financing growth. But if they became lower because of a renewal of risk aversion, or a renewal of deflation fears -- or both -- the Fed may regret its wish. So, oddly, the Fed may be *more likely* to intervene *now* that yields are lower than it was when they were higher -- indeed, the Fed first intervened by committing to buy $300 billion in Treasuries when yields were only 2.53%.

At the same time, the Fed struggles to conduct monetary policy while trying to co-operate with the Treasury to ameliorate the crisis in the banking sector. One issue of potential deflationary significance here is that the Treasury and the Fed have *no agreement between them* on what the Fed will do to fund legacy non-agency residential MBS under the Public-Private Partnership Investment Program (PPPIP). Ever since the *unilateral* statement by the Treasury on March 23 committing the Fed to as much as $1 trillion of such funding (see "Geithner Gets a Do-Over" March 24, 2009), the Fed itself has *never formally agreed to it*. A joint statement yesterday of the Fed, the FDIC and the Treasury left the matter completely unresolved -- though it is utterly central to the viability of PPPIP, and the statement's purpose was to assure markets that the program is proceeding apace. Markets were led to expect up to a $1 trillion expansion in the assets on the Fed's balance sheet -- and a massive facility for relieving banks of toxic assets -- when in fact the Fed seems to have no such intention. So if the Fed ends up having to fight deflation by buying assets, it looks like it will have to buy something other than toxic ones.

Recommended reading
The (Mythical?) Housing Wealth Effect Charles Calomiris, Stanley D. Longhofer and William Miles NBER Working Paper No. 15075, June 2009 *Platt on Working at Wal-Mart* Charles Platt Econtalk, June 15, 2009 *Fly on the Wal* Charles Platt *New York Post*, February 7, 2009
[Recommended Reading home]

Meanwhile, the White House is promoting the Fed as a new super-regulator in charge of preventing systemic risk (see "Regulation Road" June 18, 2009). With Ben Bernanke up for re-appointment by the White House in a matter of months, it's a matter of some difficulty that he is on record being quite emphatic that "the Fed cannot reliably identify bubbles in asset prices," and "even if it could identify bubbles, monetary policy is far too blunt a tool for effective use against them." This view is a unanimous consensus among experienced central bankers, with even Alan Greenspan -- he of "irrational exuberance" fame -- having said it is "very difficult to definitively identify a bubble until after the fact," or to preempt it "short of the central bank inducing a substantial contraction in economic activity--the very outcome we would be seeking to avoid." Yet now the recently appointed New York Fed president, ex-Goldman Sachs economist William Dudley, has stepped forward to declare in a speech to the Bank for International Settlements, "Asset bubbles may not be that hard to identify," and "we might give a systemic risk regulator the authority to…directly influence risk premia." Right now it's realistically all Ben Bernanke can do to *not cause* some kind of new bubble himself, having surely caused the last one -- and yet he must compete with a potential political rival who promises to prevent bubbles entirely.

Finally, another complication the Fed has to deal with in its battle against deflation is the effort by governments to artificially suppress commodity prices, especially energy. In an op-ed in yesterday's *Wall Street Journal*, the United Kingdom's prime minister Gordon Brown and France's president Nikolas Sarkozy called for what amounts to government determination of global energy prices -- "to arrive at a common long-term view on what price range would be consistent with the fundamentals." Torn between the desire to encourage growth on the one hand, and to reduce carbon emissions on the other, who knows what prices would emerge from such a "view." And the day before, new Commodities Futures Trading Commission chair Gary Gensler announced hearings on whether "federal speculative limits should be set by the CFTC to all commodities of finite supply, in particular energy commodities." All just talk, perhaps, but crude oil is off 8% in the last two days. We could see that as good news, as the recovery in energy prices was getting to be a "green overshoot" with the potential to retard recovery (see "Green Overshoots" May 29, 2009). But ultimately, the threat (or the reality) of government price controls is anti-growth. And in the short-run, the resulting distortions make it all the harder for the Fed to take price signals from the most inflation/deflation-sensitive markets -- making the risk of a deflationary error even greater than it already was.



All these are the risks. Our baseline expectation is that this deflationary correction will run its course, and that the recovery from the early March lows will resume (although how much upside there is in such a recovery is a matter that deserves serious skepticism). We are willing to see this as just a correction, but we recognize that after the near-death experience markets went through earlier this year, we can't be dismissive about the possibility that, once set in motion, the downward momentum of correction won't become self-sustaining. We still think that the recession is over, at least technically. So if we're lucky, a decent earnings season -- and this will be the first one in 18 months to take place against the backdrop of a rising forward consensus (see the chart above) -- and a continued flow of stabilizing macro data will be enough to dispel deflationary sentiment. Failing that, a catalyst would have to be some hint from the Fed -- stated in a face-saving yet nevertheless unmistakable way -- that it is back on deflation watch. We hope that won't be necessary.

BOTTOM LINE: We are working through the expected correction of the recovery from the March lows, with a distinct deflationary flavor owing to the Fed's having apparently gone off deflation-watch. The more markets revert to their deflationary patterns of late last year, the more likely that the Fed will be ultimately roused to reflate, as it did then. We think the correction is not over yet, but we are on the lookout for the next inflection point to buy stocks and inflation-sensitive assets, and sell Treasury bonds.