Something will give!

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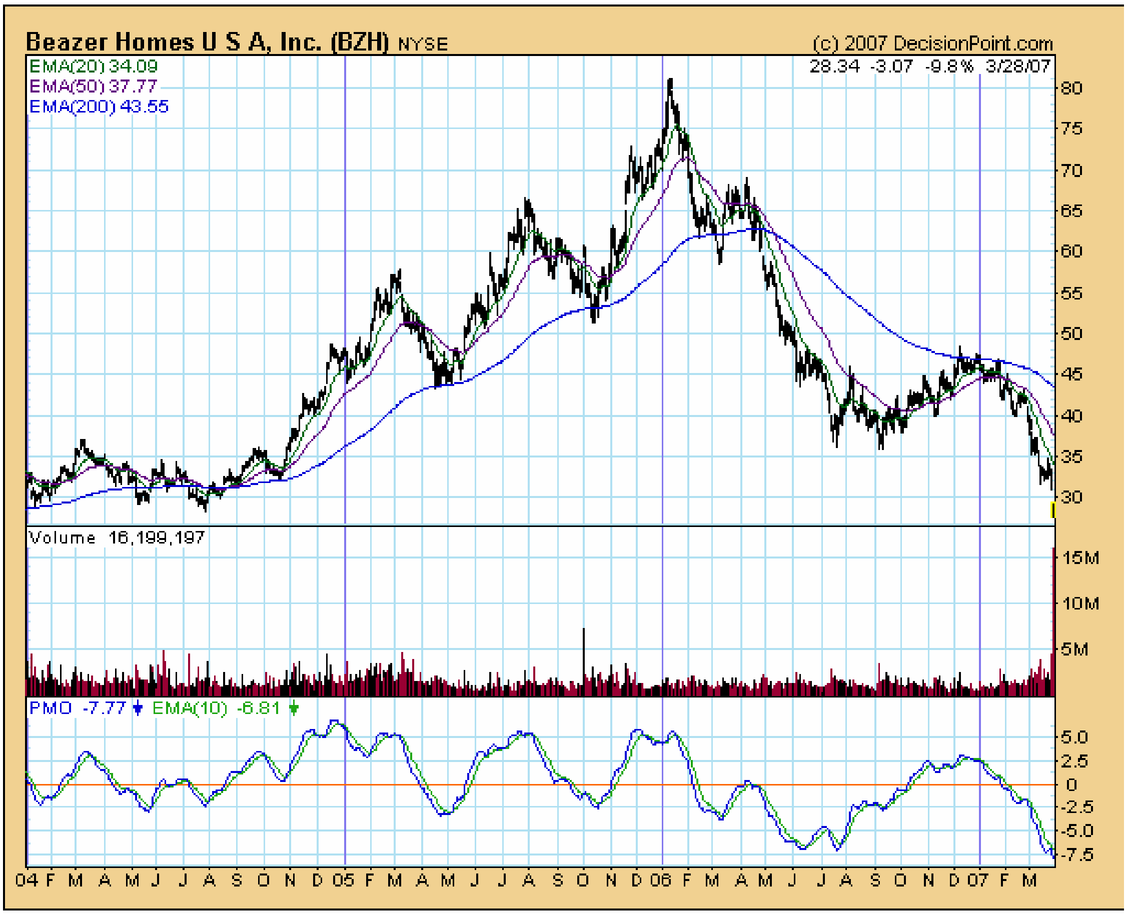
I must confess that I love the Goldilocks crowd. For them there are no problems anywhere. And if there occurs anything financially, economically or politically, which might just resemble something like a nuisance from their eternally optimistic perspective, the interpretation will be that it is a positive development for the US stock market and the global economy. (The only problem that exists for the goldilocks crowd is tight and sound money.) Consider the US housing industry (see Figure 1).

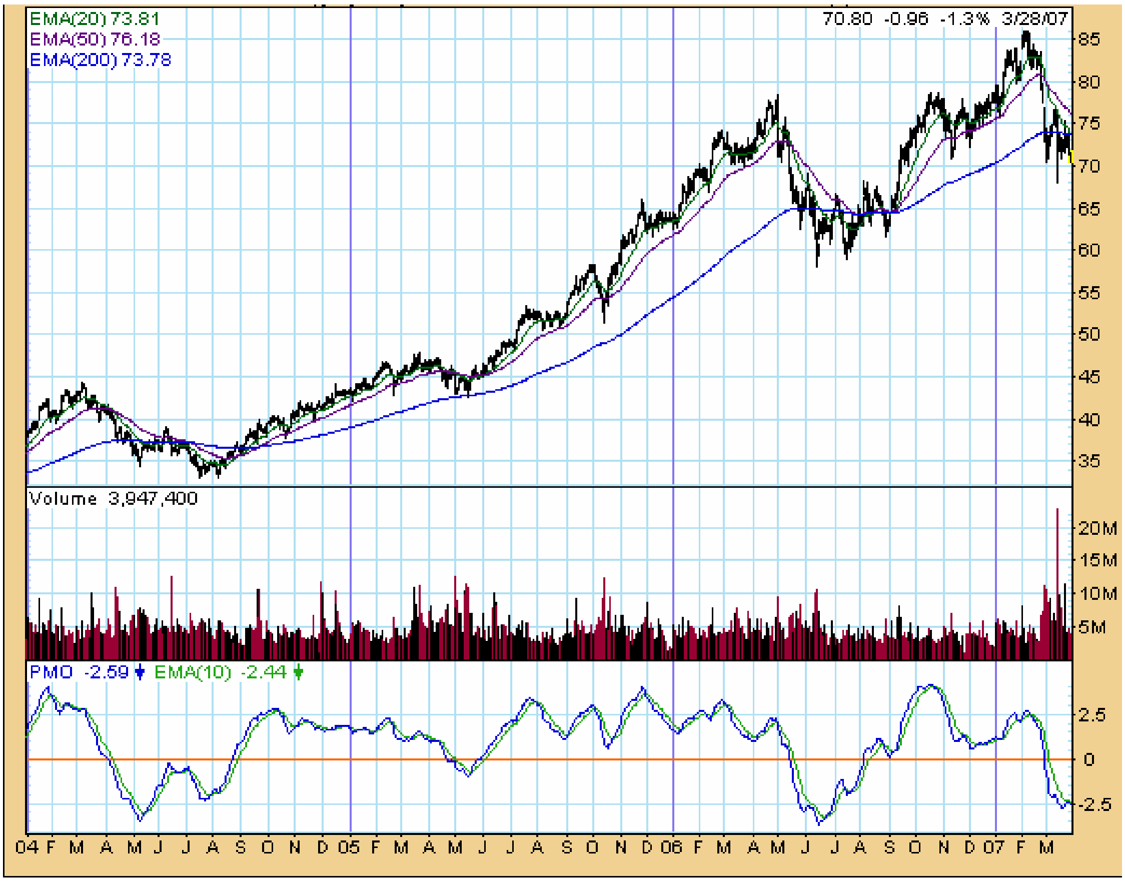
Figure 1: Has the US Housing Industry bottomed out?



Source: www.Decisionpoint.com

Home building stocks peaked out between the summer of 2005 and early 2006. Since then, housing stocks have declined by more than 50%. But all I have heard over the last 18 months (with the exception from one analyst at Credit Suisse) is that the housing market had bottomed out and was about to recover, and that the US consumer was in rock solid financial condition. However, I do agree with the Goldilocks crowd that the Fed will again cut interest rates. This, certainly, if the Dow and brokerage stocks declined by respectively 10% and 20% from their recent highs (see Figure 2)!

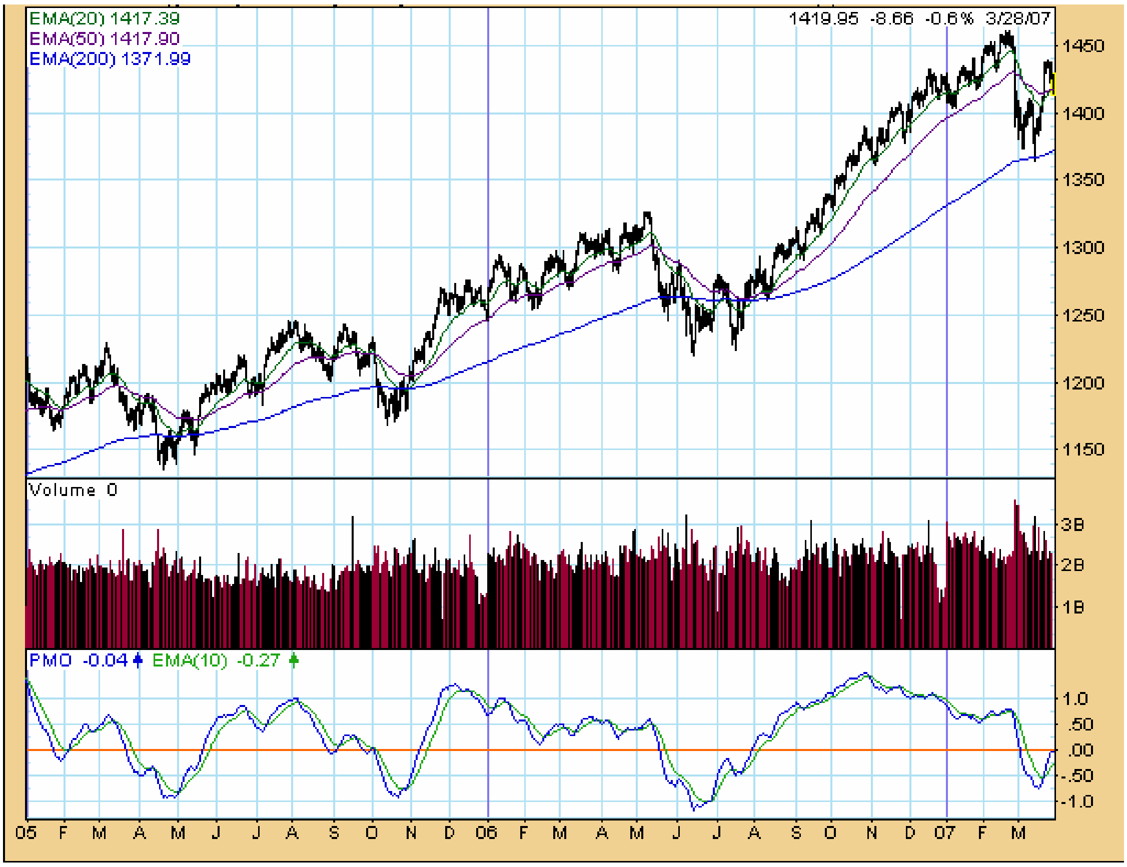
Figure 2: Lehman Brothers Holdings, 2004 – 2007



Source: www.Decisionpoint.com

Here's why! The decline in US home prices and the collapse in sub-prime lenders affect mostly poor people. The affluent class owns its homes either debt free or with plenty of equity. Don't forget that nationwide the household sector's equity amounts to over 50% of home values, which means that for most households, home prices would have to collapse totally until they would suffer financial hardship. But not so for the less affluent class and the desperados who either out of ignorance or greed borrowed close to 100% or frequently even more of the real value of their homes (with Liars' Loans). For these leveraged home owners even a 5% decline in prices can have a devastating impact on the ability to refinance, given that their creditors, which are the sub-prime lenders, have gone out of business or will shortly do so. But the situation is radically different for the owners of Wall Street firms, who are mostly well-to-do and influential individuals. So the day their wealth will be threatened by a decline in their companies' stock prices, the phones at the US Fed and the US Treasury will not stop ringing and, regardless of any inflationary pressures, interest rates will be cut in order to support the stock market (see Figure 3).

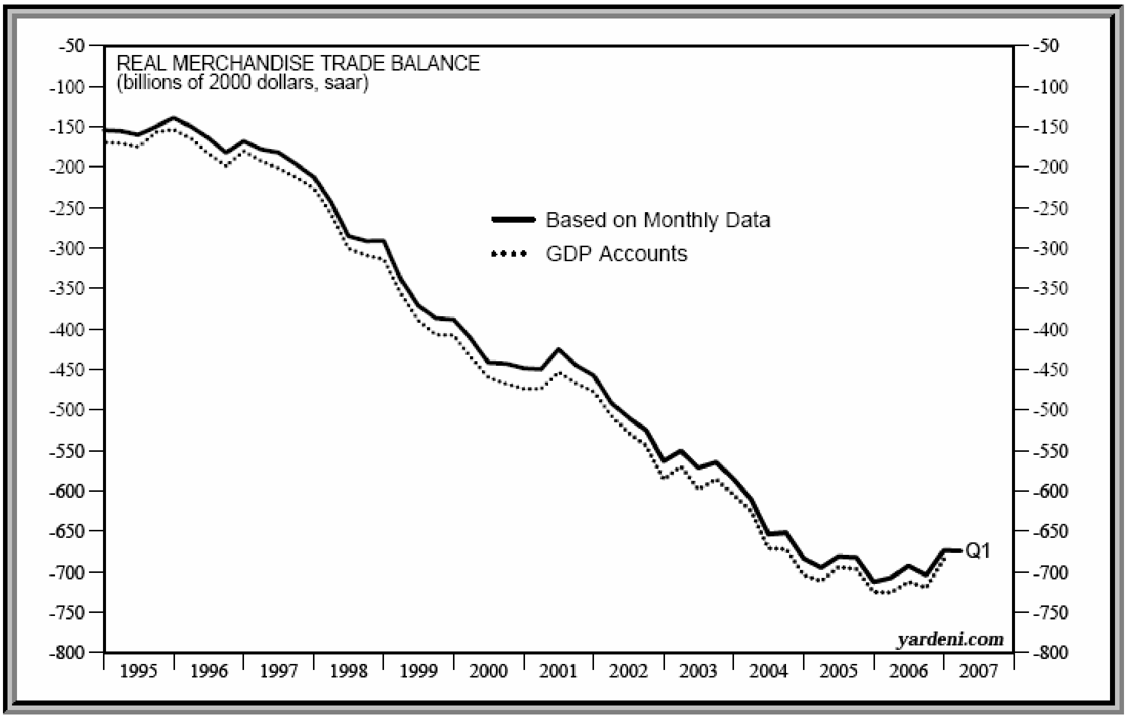
Figure 3: S&P 500, 2005 – 2007



Source: www.Decisionpoint.com

In fact, I would expect the phones to start ringing at the Fed once the S&P 500 declines below 1400 or once brokerage stocks in the US are down by 20% from their recent highs. This, I may add, is a very high confidence prediction. What is more difficult to predict, however, is if the Fed will act immediately and what would follow any Fed funds rate cuts. Also, how will financial markets react once they seriously begin to discount the next series of rate cuts? On the surface it would seem logical to expect the US dollar to weaken once the market begins to discount future interest rate cuts. But the situation may be more complicated than that. For one, I think that the US economy is already in recession, but this is hidden because the rate of inflation is understated. If the rate of inflation was properly measured one would have to subtract from nominal GDP an inflation rate of at least 5%, which would then yield a stagnating or contracting economy. A stagnant economy implies no real consumption growth, which in turn would lead the trade and current account deficit to no longer expand (see Figure 4).

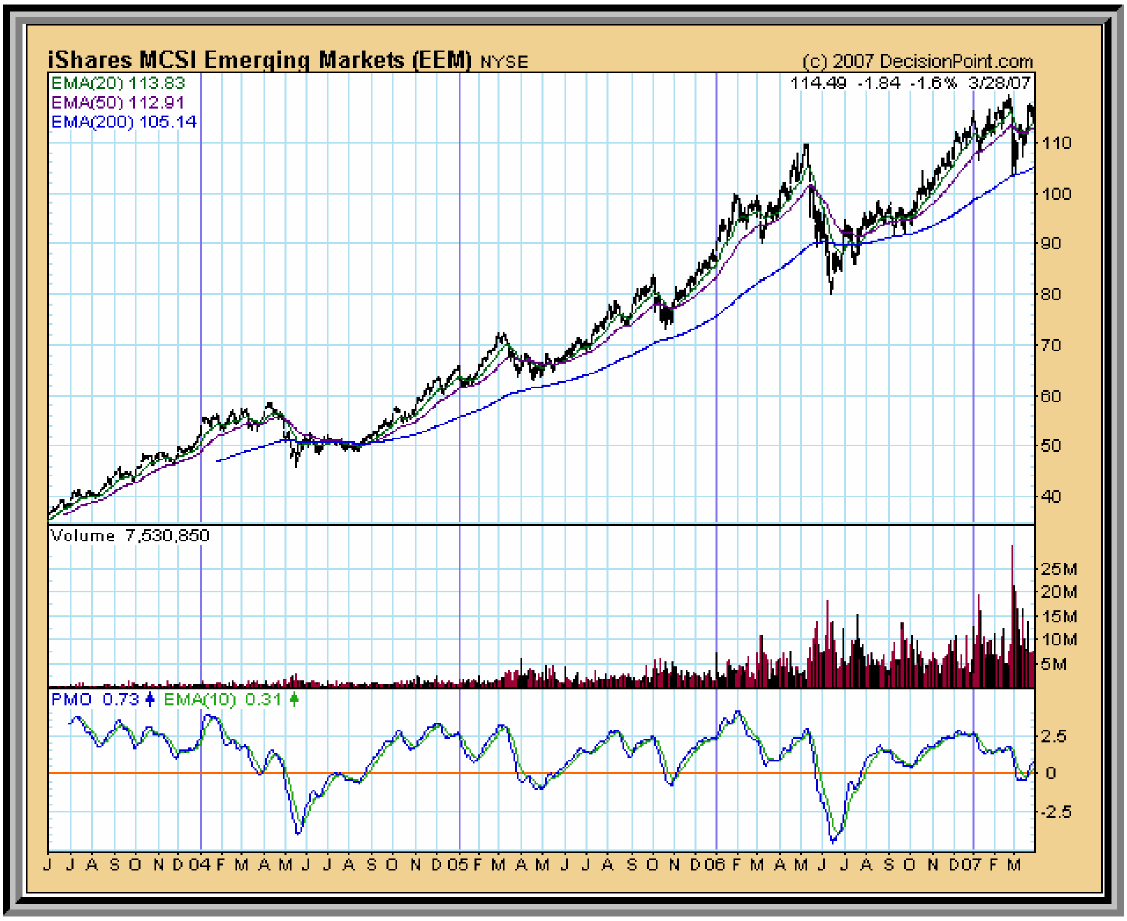
Figure 4: US Merchandise Trade Deficit, 1995 - 2007



Source: Ed Yardeni, www.yardeni.com

A current account deficit that would no longer be expanding would likely create some "relative tightening" of international liquidity (the "excess liquidity" everybody has been talking about). Such an event would likely hit emerging stock markets hardest since they were the prime beneficiaries of the tidal wave of liquidity sloshing around the world whose source was the expanding US current account deficit between 2001 and 2006 (see Figure 5).

Figure 5: Emerging Stock Markets to be avoided!



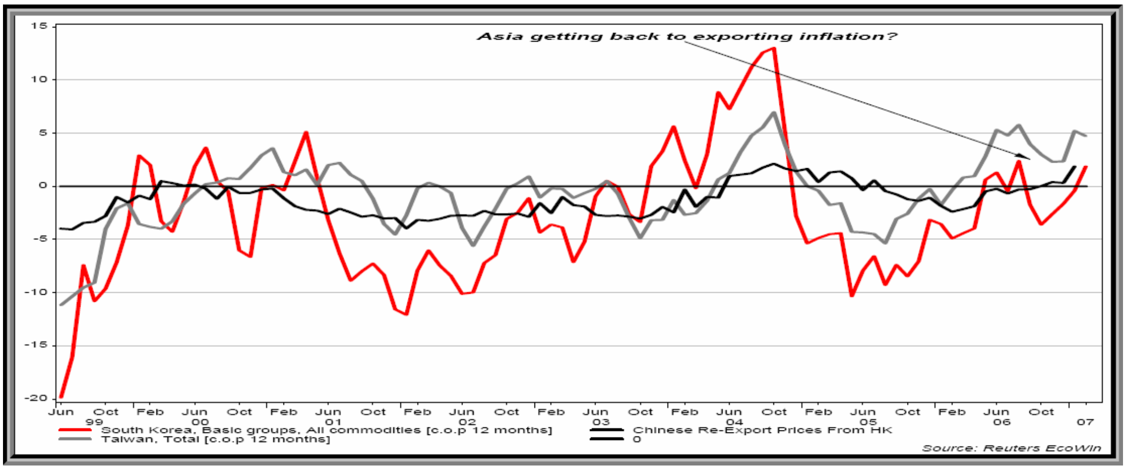
Source: www.decisonpoint.com

In turn, declining emerging stock markets would trigger, as discussed last month, some repatriation of funds into US dollars and into the Yen. This will likely support these currencies for now (whereby I would expect the Yen to appreciate against both the US dollar and the Euro).

The extend of any further US dollar weakness will also depend on interest rate movements in other parts of the world. If simultaneously to US rate cuts interest rates in Europe and elsewhere are increased, then it is likely that a more pronounced US dollar weakness could occur.

There is another point to consider regarding future US interest rate cuts. Over the last 12 months, commodity prices and in particular grain prices have been strong. Moreover, as GaveKal Research recently pointed out, China’s and other Asian countries’ export prices are no longer declining (see Figure 6).

Figure 6: Asian Export Prices

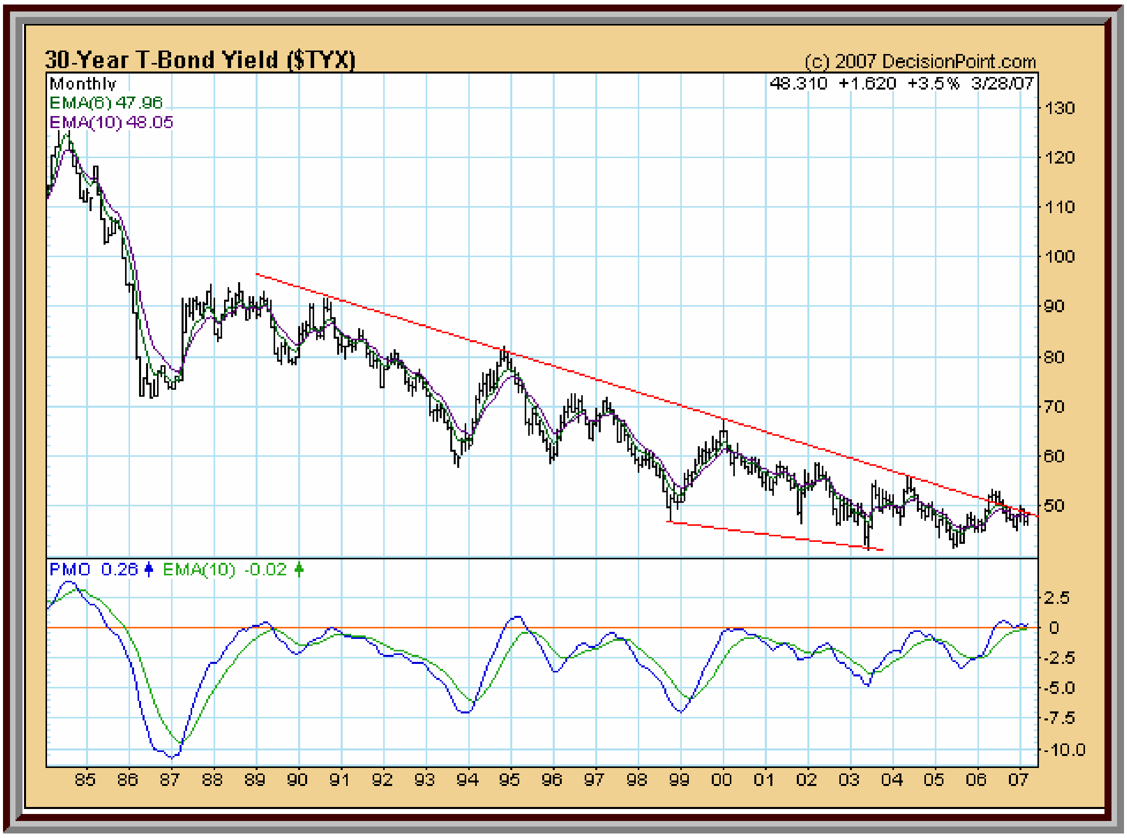


Source: GaveKal Research

So, if the Fed decided to flood the system with liquidity at the time of rising food prices and increasing import prices, and already accelerating inflationary pressures for services, it is likely that any dollar weakness would be accompanied by soaring commodity prices and more meaningful increases in import prices.

In fact, I suppose that one day the bond market and the Goldilocks crowd may wake up to the fact that energy and food price increases are a permanent, or at least a more enduring feature of the current economic environment. Therefore, when in future pricing bonds, investors will no longer pay attention to the absurdly misleading “core inflation” figures but will look at headline inflation and at the overall colossal depreciation of the US dollar’s purchasing power. So, if the Fed really decided to embark on a massive monetary easing exercise in order to support the asset markets - but at the expense of a weaker US dollar - it is likely that interest rates on longer dated bonds would begin to increase rather strongly (see Figure 7).

Figure 7: When will the US Bond Market begin to Discount Inflationary Monetary Policies?



Source: www.Decisionpoint.com

In the past, agricultural commodity prices have been one of the most reliable leading indicators of inflation. In this respect it is interesting to note that grain prices are up 70% and the PPI Farm Products is up 22% over the last year (see Figure 8 and Figure 9).

Figure 8: Grain Prices up 70% Year-on-Year

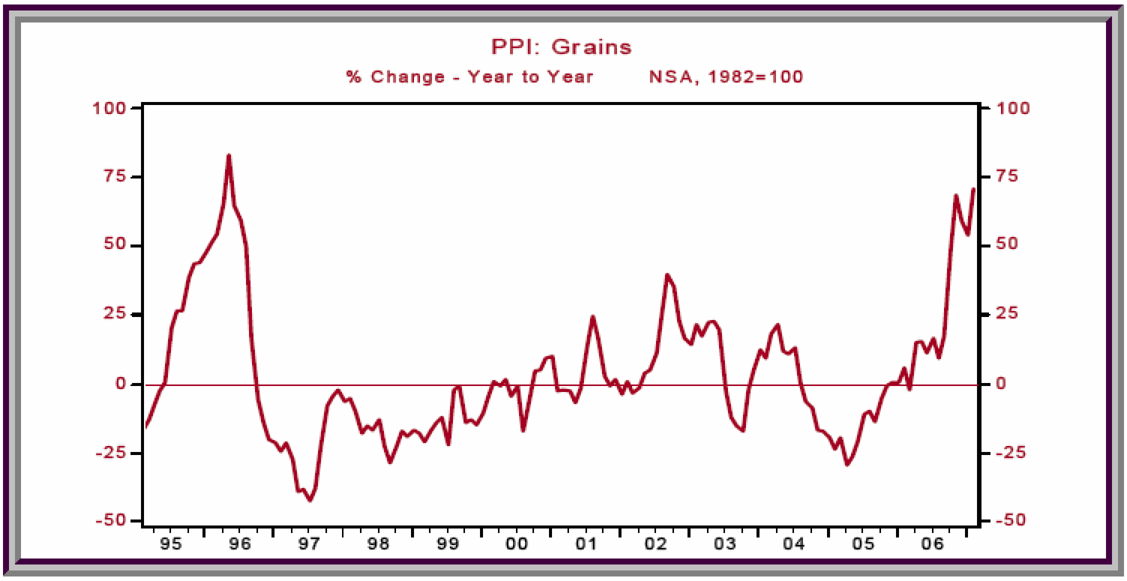
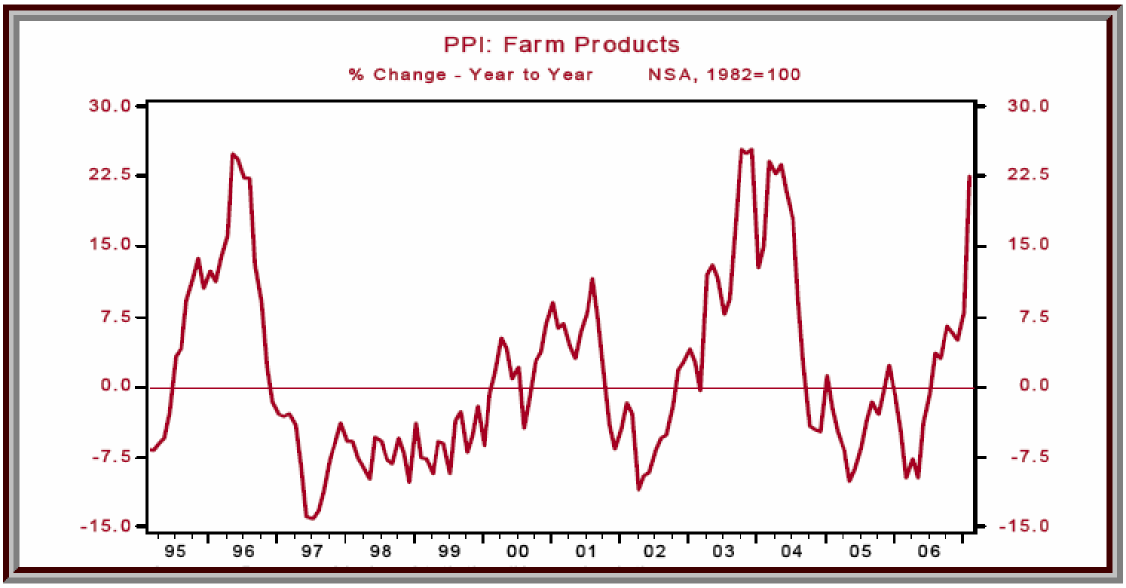


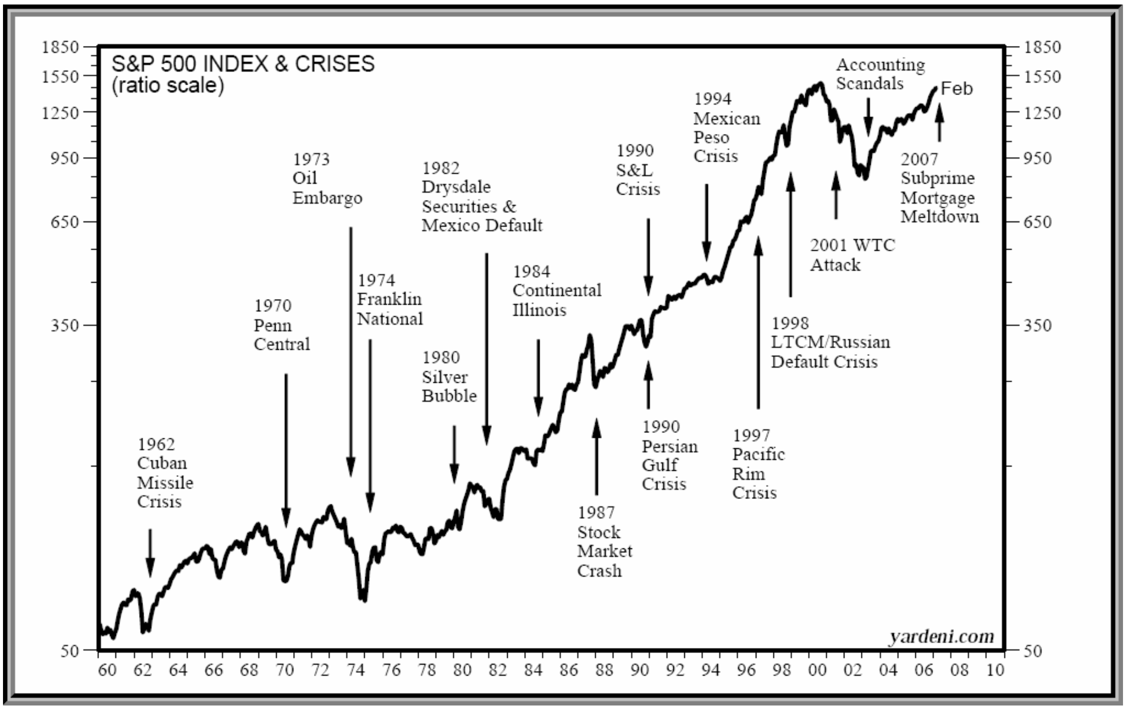
Figure 9: Farm Product Producer Prices, Annual Change, 1995 – 2007



Source: BLS, Ed Yardeni, www.yardeni.com

Now, as my regular readers will know, I have not a high esteem for central bankers and I would never even consider hiring Mr. Bernanke as my plumber, driver, or butler. But, as an academic and politician he may understand his precarious position better than he is given credit for. Should inflation under his chairmanship at the Fed become a problem, he knows that he will be blamed for it. Conversely, he is also well aware that if some sort of recession occurred due to a currently more hawkish monetary stance, financial observers will be quick to blame Mr. Greenspan for it since the former Fed chairman addressed any financial crisis or any potential problem (Y2K) by printing money (see Figure 10) and since he was the principal architect of the housing bubble.

Figure 10: Inflating Problems away!



Source: Ed Yardeni, www.yardeni.com

So, from a career and reputation risk point of view, what would you do if you were in Mr. Bernanke's shoes? In my opinion, Mr. Bernanke will move very slowly in cutting rates and rather take the risk of some mild form of a recession. He could then blame a recession, which would have come from the housing sector, on Mr. Greenspan. After that he could take some "extraordinary monetary measures" in order to engineer an economic recovery for which he would take credit. And should at that time inflationary pressures have failed to abate or even increased – as I would expect them to do – he could always argue that the Fed's policy priorities have temporary shifted to emphasize "economic growth" over "targeting inflation", and that the Fed would deal with inflation once the economy had fully recovered. The stance of emphasizing "economic growth" over "inflation targeting" would at that time be also politically perfectly acceptable and welcome by the "establishment", which would have taken advantage of a bear market in housing and hardship among sub-prime borrowers to acquire some assets at bargain prices….

I am mentioning this because as my friend Bill King, author of "The King Report" (billking@ramkingsec.com) reported, Ben Bernanke recently gave a speech at Stanford in which he said that "increased trade with China has reduced U.S. inflation, now running at about 2%, by only about 0.1 percentage point". He also noted that while emerging economies have added to the global supply of manufactured goods, they are also adding to the demand for oil and other commodities. And according to Mr. Bernanke, "There seems to be little basis for concluding that globalization overall has significantly reduced inflation in the U.S. in recent years; indeed, the opposite may be true."

And this is where I think the Goldilocks crowd, which argues for continuous economic growth, will be as wrong as it has been for the last few years. The super-bulls on the US simply overlooked the fact that strong economic growth in China, India, Vietnam, and other emerging regions of the world would lead to soaring commodity prices whose price gains significantly outstripped the performance of US financial asset prices. So, I assume that commodity prices will continue to outperform financial assets in the remote case that the Goldilocks protagonists should prove to be right.

But to put it very simply, I think that the Fed will not flood the system with liquidity right away, as its chairman only knows too well that he can do that at any time in the future, with whatever monetary injection it will take. I suppose it will then take a gigantic injection and that it will be very inflationary and produce no economic growth. But for now I expect that relative monetary restraint by the Fed implies for financial markets to - at best –hold around the current level, but more likely to enter a more meaningful decline than we had at any time since the asset markets began to rally in March 2003.

There is some seasonal strength between the end of March and the end of April and, therefore, stock markets around the world may hold or even rebound modestly, but we would use rallies as selling opportunities. In particular we would avoid financials, housing related stocks, and retailers.

I still like gold and silver, although in the environment of "relative tightening", I referred to above, price corrections in precious metals should not be excluded.