Domestic Research
Polyconomics, Inc.

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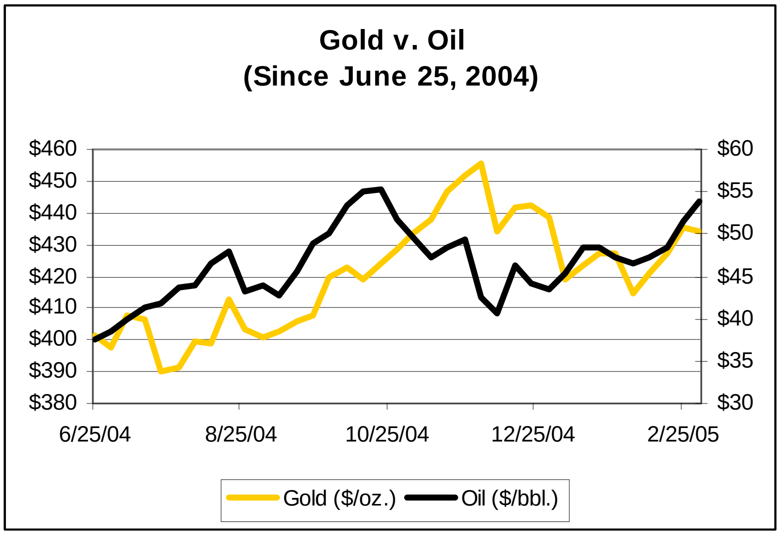
FYI: More Dark Clouds

Since our February 23 report "Good News in Short Supply," the equity markets are a bit higher, but so is the price of gold and so is the price of oil. This means we can't really allow ourselves to feel too happy about nominal equity prices more or less on the rise. Yes, there have been good earnings reports in recent weeks, but they reflect what has been, not what is going to be. And to a degree, they are also not entirely real given the fact that the whole economic system is experiencing a monetary inflation. To be really happy about the near future, we would need to see the stock market indices rising against the backdrop of a flat dollar/gold price.

Here, for example, are the nominal returns for the major stock indices since June 30, 2004, when the Federal Reserve began its policy of raising the federal funds rate to combat an imagined inflation: 1) S&P 500: +5.80%; 2) Dow: +3.55%; 3) Nasdaq: +0.66%. The real returns (in gold terms) for the same period are: 1) S&P 500: -5.34%; 2) Dow: -7.36%; 3) Nasdaq: -9.94%. To be sure, the dollar/gold price is the leading edge of an inflation that will unfold over time and the equity prices represent today's purchasing power. But the oil price doesn't take as much time to catch up with gold as it did 25 years ago, as the chart below indicates. Wall Street will struggle more than it has since Feb. 23 as the implications of higher oil and commodity prices feed into the markets.



If we look back a little further, to February 16, we see that the relative optimism in the markets ended that day as Fed Chairman Alan Greenspan explained to Congress that the failure of long-term rates to rise along with the funds rate going to 2.5% from 1% was a “conundrum,” adding that the funds rate was still “relatively low.” This was not good news for the bond market in particular, as it was being advised the Fed was not going to slow its moderate pace of interest-rate hikes and might even speed them up. Fed funds futures earlier in February had been pricing a funds rate near 3.5% at year’s end, with pauses along the way for the Fed to look around. But with Fed Governor Ben Bernanke this week echoing Greenspan’s comment about the funds rate being “relatively low,” futures are now heading toward 4% by year’s end.

In our analytical framework, which has been fairly accurate in seeing Fed policy as being inflationary, not corrective, the 10-year note was reasonably priced at 4.25% with gold at $420/oz.; and gold would have to go to $450, more or less, for the 10-year to hit 4.5%. That call is now looking respectable, with gold at $441 and the 10-year at 4.52%. If Greenspan and Bernanke refuse to acknowledge that they have been creating an inflation with their experiment in search of the right funds rate, they will instead watch the higher CPI statistics roll in during the balance of the year and decide the funds rate may have to go as high as 5% by year’s end, which is where the economists at Bear Stearns want it. On that perverse path, gold will be approaching $500 and the 10-year will be above 5%. More or less, we would add. After all, we are in experimental terrain, all of us.

Jude Wanniski and Paul Hoffmeister