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Scary Kerry?

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Markets are assessing the dangerous interaction of a Kerry win and a Fed mistake.

Today's disappointing jobs numbers no doubt will have **John Kerry** loaded for bear tonight in his face-off with **President Bush**, with the media already advancing his case that the sub-par pace of hiring remains a blight on the Bush economic record. If Kerry sees the labor market as among factors giving him a fighting chance of capturing the **White House**, there are signs that the markets may agree. We have tracked since early this year the close correlation between changes in Bush's re-election probabilities and equity market performance. Today, as one might expect, the Bush futures contracts at **Tradesports.com** fell slightly on a bad day for stocks. But in assessing risk factors at work in the current politically charged environment, we were also intrigued that coincident with release of the employment data, gold shot up $5 to a six-month high above $422, and the dollar tanked as expectations for Fed rate-hiking action receded.

Admittedly, we can't exclude the possibility that these market responses would have happened regardless of the political context. But at this point in the campaign, with election day little more than three weeks away, it's hardly a stretch to posit that, at the margin at least, participants in the market for dollar liquidity are positioning for the risk of a Kerry victory. With his domestic-policy appeal framed as a response to lackluster payroll growth under Bush, the risk is that a Kerry win would be dollar-negative. With **the Fed** still in a highly accommodative stance, any political influence -- whether overt or not -- that results in a slowing of the policy normalization process could have significant inflationary consequences.

That risk certainly wasn't mitigated by the remarks this week of various central bank officials suggesting that they continue to be guided primarily by the dictates of economic fine-tuning, rather than that of safeguarding the unit of account. Once again engaging in his role as the Fed's most consistently dovish figure, **governor Ben Bernanke** essentially endorsed the bond market's repricing of policy expectations over the past several months. "The FOMC will watch the data as it arrives," he said. "If a slowing of the economy…justifies a pause, that will certainly be the response." Perhaps more surprising, **Dallas Fed president Robert McTeer** -- who at times espouses principles that can be considered supply-side -- gave much the same outlook, offering that while up to this point the Fed has been in "the mood to get interest rates up" regardless of the data, "we are getting to the point where it's data dependent."

But McTeer, however inadvertently, also raised questions about the Fed's intentions, suggesting that "over time there's only one direction for the dollar to go -- lower." Ostensibly, he was referring to a weaker dollar as part of a "solution" to the **US** current account deficit. Strangely, though, he also raised the specter of a crisis marked by "rapidly rising interest rates and a rapidly depreciating dollar" if the ability of the US to fund its current account deficit is cast into serious doubt. Of course, one sure way to precipitate such a crisis is to give credence to speculation that the monetary authorities are seeking to cheapen the currency.

It strikes us, meanwhile, that this is a particularly inopportune moment for policymakers to be raising any doubt about their commitment to preserve the currency's purchasing power. In the past several weeks, we have observed a close correlation between gold and crude oil prices. It appears that a tipping point was reached when crude breached levels around $42 per barrel early last month. Since then, regression analysis shows a correlation coefficient of 82% between gold and oil prices. Up until that point, the correlation was only 13% over the prior eight months. This suggests that the risk that monetary policy will accommodate the oil price spike in the general price level has risen appreciably, and that the last thing Fed officials should be inviting is speculation about their intent to continue the policy normalization process. TM