TrendMacrolytics

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Walk the Hawk

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The "inflation plays" smell blood in Ben Bernanke's water.

Update to strategic view
INFLATION PLAYS (GOLD, OIL, COMMODITIES, US RESOURCE STOCKS): Inflation-sensitive markets have rebounded as the Fed has talked tough on inflation while acting weak. We continue to look for a challenge to the highs as these markets put Ben Bernanke to the test. **US DOLLAR:** The same factors argue for the continued decline in the dollar versus foreign currencies.
[see Investment Strategy Dashboard]

The "inflation plays" have come very much back to life. Two months ago, in the immediate wake of the blow-up of the Amaranth hedge fund, we reiterated our conviction that energy, commodities and resource stocks would rebound -- and that the dollar's decline would resume -- after what we characterized as a speculative purging (see "The Frustrated Fed" September 28, 2006). Since saying then "It's time to catch the falling knife," commodities have rebounded across the board. Energy (up 12.4%) and basic materials (up 9.2%) have been the two best performing S&P 500 sectors, and the US Dollar Index has fallen 2.6%.

These inflation-sensitive markets were subdued following their May highs (except for energy, which reached its highs in July) by strong anti-inflation rhetoric from Fed chair Ben Bernanke (see "Bernanke Arrives" June 6, 2006). Bernanke's tough talk at the time was aimed explicitly at controlling what he saw then as accelerating inflation expectations embodied in these markets. But having *talked* hawkish, Bernanke *acted* dovish. The Fed went on pause at the August 8 FOMC meeting, leaving monetary policy in an accommodative posture with interest rates still below equilibrium, and still imparting new inflationary pressures into the economy (see "The Price of the Pause" November 1, 2006). So in our view it has been just a matter of time before resurgent inflation-sensitive markets would put Bernanke to the test.

By pausing to soon, Bernanke pulled back from the anti-inflation "line in the sand" that he drew with his tough talk in early summer. With inflation-sensitive markets having cooled in response, Bernanke declared "mission accomplished" and pulled back from that line (see "If Only It Were This Easy" August18, 2006). But markets are bullies -- they sense weakness and challenge it. It looks like it's time to see if Bernanke can not only talk the hawk, but walk the hawk as well.

Bernanke must sense that such a challenge is mounting. He stayed silent on policy matters for four months (see "Indian Summer" November 21, 2006). The timing of his policy speech Tuesday must surely have been, in no small part, a response to mounting volatility in futures markets for Fed expectations and the recent sharp decline in the dollar. Yet it seems the speech has been regarded by markets as just more talk -- and not even very honest talk, at that, with Bernanke having not even mentioned the alarming fall of the dollar on forex markets (see "Testing Bernanke" November 29, 2006). In response to that speech, for all its seeming hawkish bias on inflation and confidence in the robustness of the economy, fixed income markets only

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deepened their expectations for rate cuts in 2007. Crude oil and gold have continued to rally, and the dollar has continued to fall.

We continue to anchor the hawkish extreme in the inflation outlook among economists. We are not fooled by temporary spikes down in headline inflation, driven by the recent drop in energy prices -- by all *core* measures, inflation continues to be running at levels well above anything the Fed should consider consistent with price stability (see "Inflation Mission Accomplished? Not So Fast" November 20, 2006). We believe that the bond market is as wrong today as it was throughout most of the 1960s and 1970s in underestimating future inflation (see "Judgment Day" August 3, 2006). And we draw no comfort from the fact that gold, crude oil and other commodities are off their highs. Even at their lows this summer they implied pipelined inflationary pressures that would result in core CPI inflation running, on average, in excess of 4% over the coming decade (see "Weak Gold, Strong Inflation" September 13, 2006). Now they are no longer at those lows, and we believe they may well be headed back to the highs.

BOTTOM LINE: The Fed talks tough, but acts weak. For months, inflation-sensitive markets have been cowed by the tough talk. But with every day the Fed stays on pause below equilibrium rates, compounding inflation pressures are imparted into the economy. Inflation-sensitive markets have gradually rebounded in response. With Bernanke's first major policy speech in over four months having done so little to re-establish his hawkish *bona fides*, inflation-sensitive markets should continue to be resurgent over the coming months. Unless and until Bernanke intervenes, these markets should challenge their highs, thus challenging Bernanke's "line in the sand" drawn in early summer. Bernanke is unlikely to act to head off this challenge proactively-- on the contrary, it is the challenge itself that will finally trigger Bernanke to act.