TrendMacrolytics

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Something's Survived

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The inflation plays are the winners in the market's recent turbulence.

Markets have moved violently to correct some of the risk-taking excesses in credit markets that have accumulated during an era of excessively loose Fed monetary policy (see "Risky Business" March 7, 2007). But that policy itself remains in place. In fact, markets are acting as though the recent turbulent normalization of the price of risk were cause for the Fed to extend or accelerate that policy. Over the last two volatile weeks, fixed income markets have upped their Fed easing expectations to two rate cuts by calendar year-end, and perhaps a third one twelve months out. The belief seems to be that the Fed will move to inject additional liquidity into a market already awash with liquidity, as though the Fed would find it unacceptable to see credit spreads retreat even a little bit from their historic narrow levels.

On the plus side, with the Fed unlikely to become restrictively tight anytime soon, for the time being the Fed is out of the picture as a barrier to reaccelerating growth. So we are able to stand by our initial take that, for equities, the correction of the last two weeks is just that -- a correction, and not a turning point (see "Are We Scared Yet?" February 28, 2007). At the same time, the consequence of the Fed being sidelined is to intensify the inflation pressures that we believe are the dominant element on the forecast horizon. That's why we wrote last week that inflation plays were the place to start bargain hunting during the present correction. That's been the right call.

Update to strategic view

US STOCKS: We continue to believe that the present decline is nothing but a correction. We have no particular conviction that we have already seen the exact lows, but we don't think the recent turbulence signals a long-term turning point. **INFLATION PLAYS (US RESOURCE STOCKS, US ENERGY STOCKS, GOLD, COMMODITIES, US DOLLAR):** Inflation plays have been the best performers during the recent turbulence. With a crisis atmosphere likely to keep the Fed on pause longer than it would have been otherwise, we see continued easy financial conditions and inflation pressures driving the inflation-sensitive markets higher (and the dollar lower).

[see Investment Strategy Dashboard]

- Since the February 16 top, the S&P 500 has fallen 4.6%. Yet crude oil is up 6.5%, and energy is the best performing S&P 500 sector, off only 0.8%, edging out even the event-driven utilities sector.
- From the March 5 bottom, the S&P 500 is up 1.3%. Crude is up 3.4%, and gold is up 1.7%. The dollar has fallen 0.5%. Energy and basic materials are the two best performing S&P 500 sectors

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- The financial sector might have seemed like a better candidate for a bounce. From the February 16 top to the March 5 bottom, it was the worst performing sector, off 7.9%, the victim of concerns about a credit collapse in the subprime market (see "Subprime Time" February 26, 2007). Yet even as those concerns suddenly moderated this week, the financial sector was outperformed by the inflation-sensitive sectors.

BOTTOM LINE: Could the inflation plays ask for a moment more perfect than this one? Reported inflation statistics are turning back up, but drowned out by worries about subprime lending and the yen carry trade (see "Carried Away" March 1, 2007). Liquidity is still plentiful enough to easily finance speculative risk-taking. And there's enough of a crisis atmosphere to keep the Fed on hold at an inflationary level of interest rates. The moment won't last forever. We continue to believe that, in the coming months, both growth and inflation will prove to be stronger than the Fed expects or is willing to tolerate. The next rate move from the Fed will be higher -- it's just a question of when. It's notable that for all the extravagant easing expectations priced into fixed income markets now, those expectations are actually substantially more modest than they were early last December. Markets are gradually converging on reality. But in the meantime, the dominant reality is that the Fed is still easy. That will sustain the eventual recovery from the present correction -- and inflation. TM