



Lombard Street Research

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Ben pours flames on troubled oil

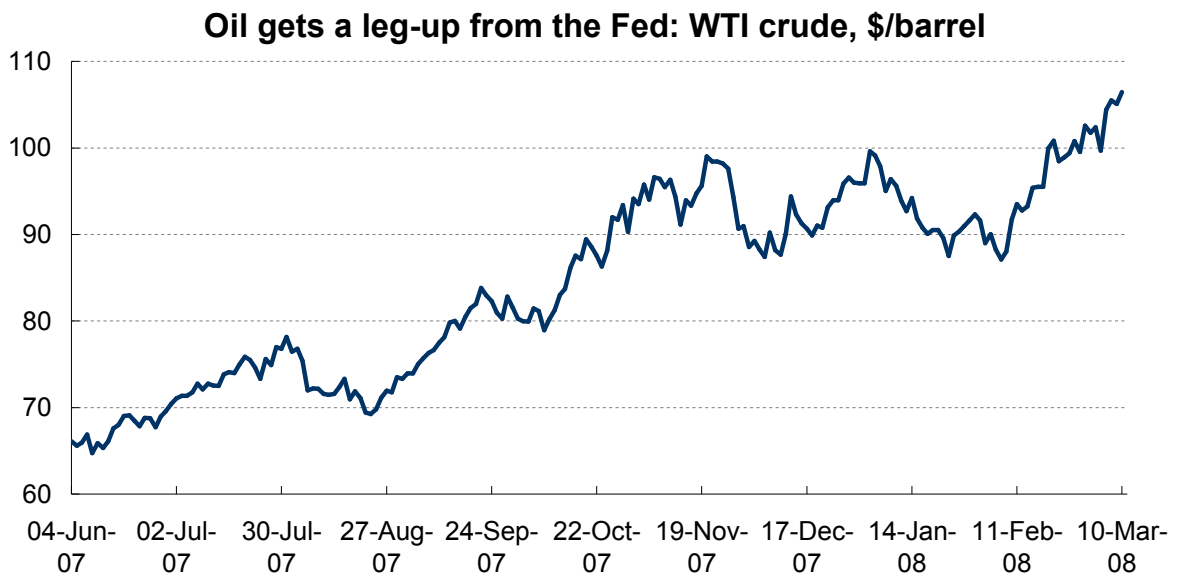
WE SUGGEST: Active stimulus to inflation bad for stocks

SUMMARY: The Fed's adoption of panicky rate cuts is causing a flight from the dollar and into commodities. This is raising inflation and reducing real income, so the recession is worsened. Global investors' revulsion from private-sector dollar risk, and from potential inflation, is meanwhile increasing the chance of a systemic melt-down, as symbolised by the newly negative yield on five-year inflation-protected TIPS.

It's an each-way bet: either the Fed's panicky rate cuts lessen the recession, or they do not.

- If they do not, or (as we believe) they worsen it, profits are going to be hammered; meanwhile global revulsion from interest-bearing dollar assets will worsen the credit crunch and destroy dollar financial market function
- If they do lessen the recession, the much stimulated inflation will require a rapid reversion upward in interest rates, aborting economic and stock market recovery

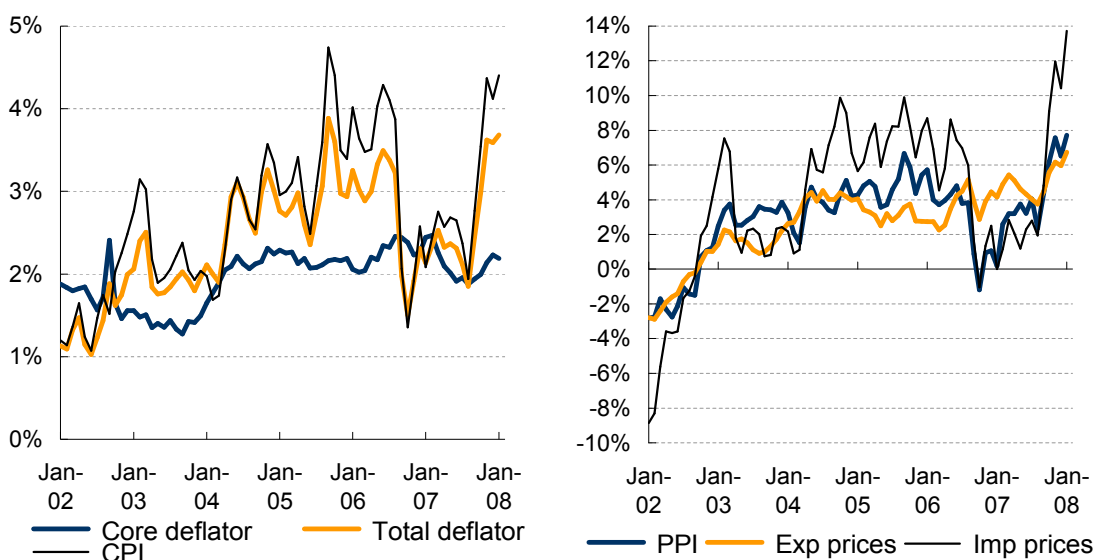
Either way, the Fed's lunatic gamble is likely to end in disaster.



Obviously everybody at the Fed walks to work. They probably do not eat either, to achieve the level of hallucination needed to believe that only the “core” inflation index, ex-food and energy, matters. But as the chart below shows, the rate of inflation actually affecting the buying power of Americans is 4¼%: 3¾% if their flight from the more inflationary

items, as recorded in the changing pattern of actual consumer spending, is allowed for. And that was in January, since when more than 15% has gone on the crude oil price, which is up by more than half since the credit crunch started. Of course, this not a single-cause price. Clearly, wasteful use of price-controlled energy in rapid-growth Asia is boosting demand. And multiple political and “geo-political” (read war-mongering) shenanigans in the Middle East and the former Soviet Union are aggravating supply-side fears. But “investment” in commodities (“hard assets”) is also rampant to a degree hitherto unknown, and recently this has been heftily boosted by flight from the dollar, provoked by the Fed.

Flight from dollar (inflation) adds to inflation



If the Fed and its acolytes are right that the wage response to all this rising inflation will be nil, then real incomes are being hit even harder than they would have been otherwise. So the recession will be worse. That means the house price decline will be worse, so that the eventual savings upswing – or rather collapse of household borrowing – will be greater, so the recession will be worse still. And so on. (We have not even started on business cap-ex!) And if the wage response to rising inflation is not nil, then getting rid of inflation will be no picnic.

So why the panic? Does the Fed think a raft of major banks is broke? If so, we shall know pretty soon. The sooner the better in fact – one sensible thing Mr Bernanke has said was last week’s exhortation of banks to full information and disclosure. If they are broke, then remedial action, certainly involving the Treasury, not just the Fed, will be essential before lower interest rates can benefit anyone. And if it just a liquidity problem, panic action on interest rates, as opposed to providing liquidity, is unnecessary: ask Mr Trichet. In fact, the less the impression of Wall Street being feather-bedded the greater the incentive to quick action by banks to show their solvency and get cheaper funding.

Meanwhile, the US deficit is effectively funded by the build-up of Chinese reserves, as its citizens sit behind their exchange control wall getting real returns of minus 3% on their deposits. But China does not like private-sector dollar risk any more than anyone else. So it goes for Treasuries: the Ted spread (between interbank deposits and T-bills) is rapidly

widening again. And if you also dislike inflation prospects, you prefer inflation-protected Treasuries (TIPS). The five year TIPS yield has just dipped below zero.

Investors are now locking in five years of guaranteed negative real returns just for the assurance of protection from private-sector risk and inflation risk. Supporters of the Fed's policy – many of them working for major banks, by a curious coincidence – say the risk of system melt-down does not bear contemplating: so the Fed is forced to emergency cuts. But it could be the obviously panic-stricken cuts that will trigger the systemic melt-down.

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