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MAS041504

Market Pivots: Geopolitics versus Monetary Politics

While earnings reports continue to impact individual stocks, in our view, the overall market conditions (behavior toward risk, valuation parameters, etc.) are now highly sensitized to geopolitical (and domestic political) risks and the likely future course of monetary actions by the Fed. In light of the recent inflation data that suggest an acceleration of prices and a higher average level of inflation over the past six months and the likelihood that this trend can continue somewhat going forward, one of the Fed's "pre-conditions" for changing monetary policy settings is now nearly established. (the defeat of 'deflation'). Thus, the Fed's attention must shift toward adjusting the FF rate toward a path of monetary neutrality. In fact, the acceleration of inflation, however, means that the 'real FF rate' is probably now negative (based on an assumed rate of inflation going forward of between 1.5 and 2.0%). On that basis, recent FEDSPEAK seems to suggest movements in the FF rate much earlier than the benign forecasts of "no moves until 2005" or the very optimistic characterizations that suggested "no moves until 2006." While we never believed either of these, the issue is what the "Market Believed or now Believes?" The next question to ask is whether this Fed could make an adjustment before the election in spite of the potential parallel consequence of jeopardizing the re-election of Bush II. In the end, we feel that the FED will act as a non-political Central Bank. If the consensus at the FOMC directs a move upward in the FF rate during the summer this year (pre-election), we will get one. Further, the market will turn to thinking about 2005 and how far up the scale FF's need to move to create a 'neutral real rate.' This takes us into a "never-never" land that suggests a real FF rate of say 2% or more which implies a 3.5-4.0% nominal FF rate. That means that critical issue for markets will be to estimate the "path" and the "level" simultaneously while the economy uses up its "slack." At best, these are conjectures and they must lead to a higher level of uncertainty for market participants and a consequent elevation of equity risk.

Last night we noticed that some analysts (Lehman's for example) have the first move as early as June. Our own view at this time is that it is more likely after the political conventions, but if one views the Fed's decision as fundamentally economic and not political, it will be the data that do the talking.

Here is a thoughtful expression on the problem from this morning's data feed.

Modest US inflation is back:

But no cause for monetary or market alarm

The headline figure was doubtless scary in some degree. Core US CPI rose at a 2.9% p.a. rate in the 1st three months of this year. Total CPI inflation (including food and energy prices) rose at 5.1% during the same period.

The year-on-year figures show a less dramatic picture. Core CPI at end-March 2004 is up 1.6% from March 2003. The overall CPI is up 1.7%

And as to the 6-month picture – core CPI in March 2004 was up 1.9% p.a. (compared to September 2003) compared to 1.3% p.a. September 2003 (compared to March 2003). Overall CPI was up 2.3% p.a. in the 6 months to March 2004 compared to 1.2% p.a. in the 6 months to September 2003.

ECOMENTARY? is published for clients of **Munk Advisory Services, LLC**
955 Mt. Moro Road, Villanova, PA 19085. tel (610) 527 5368 fax (610) 527 5068

Website www.ecomentary.com. Contact: munkb@ecomentary.com

These last 6-month comparisons are the most reliable guide to what is going on. A look at individual components show that the broad category of service sector inflation is broadly unchanged at around 2.7% p.a.. But there has been a jump in goods price inflation (from previous deflation), reflecting principally the jump in energy prices. Historically there is always some spill-over from energy price inflation into measures of core inflation (due to energy price rises pushing other prices upwards) and that is what has happened most recently.

But there is no basis as yet for predicting that the energy-induced acceleration of inflation in recent months is indeed the new steady state inflation. Most probably core inflation will settle back into a 1.5% + p.a. range through the rest of this year, with some tendency to rise towards 2% into next Winter.

Hourly wage-rate increases may pick up slightly in response to the higher recorded inflation of recent months, but are surely unlikely to accelerate on a year-over-year basis. (Thus they would still run at just below 3% year-on-year). With productivity increasing still at around say 3% p.a., unit labor costs may have stopped falling, but they are not rising either. The 1.5%-2% p.a. core rate of inflation forecast over the next several quarters is mainly a reflection of raised non-labor input prices including housing and health costs.

As regards Federal Reserve policy, the FOMC will now perceive that the target Federal Funds rate has fallen to negative levels – around –0.5 to -1.0%, taking the new core rate of inflation at around 1.5-2% p.a.. That is surely too low, even given the huge slack in the labor market. Policy-makers would most probably like to see a say 1.75% Federal Funds rate as soon as possible (equivalent to 0 real rate) – and can be expected to make this adjustment during the course of the Summer quarter (say June to August).

There might then be a long policy pause until substantial narrowing of slack has occurred in the labor markets. After the Presidential elections some further tightening is indeed likely, bringing the Federal Funds rate into a 2-2.5% range early into 2005. At that stage further moves depend on the course of the economy. If indeed at that stage a growth cycle downturn begins to emerge – in response to a stalling of the capital spending boom in the wake of the withdrawal of tax incentives (which expire at the end of this year) – there may be no further monetary tightening, and indeed some easing, for a long time beyond.

Economic data/events today:

?? New York Empire State survey

?? Federal Reserve Governor Bernanke speech (Chicago)

?? US Philadelphia Fed index (Mar)