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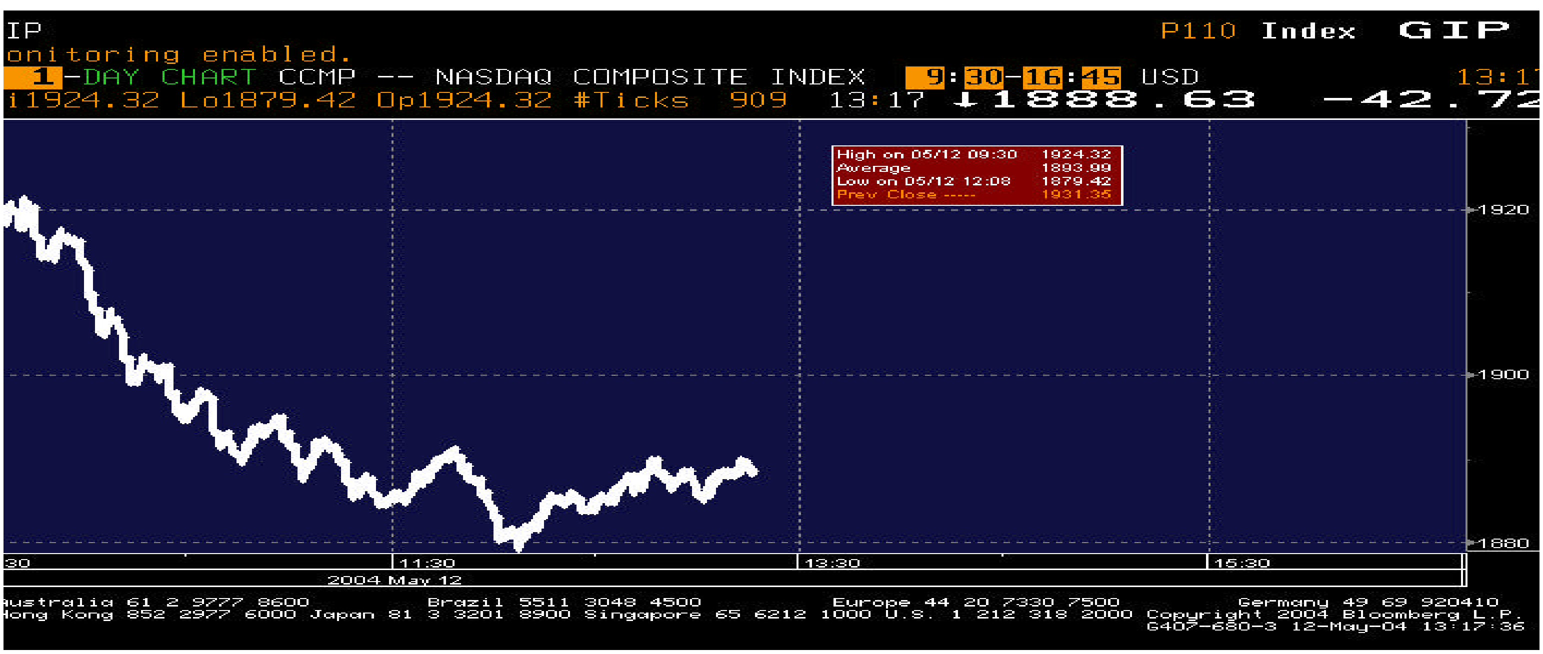
Who Moved My Cheese

The question for traders and investors today is "who moved my cheese?" Here's the issue: bond traders have the view that the inflation rate is still a bit up in the air—and it is not completely clear that the Fed cannot execute a measured pace of movi ng Fed Funds to a neutral setting without strong disruption in asset markets. The measured scenario would include modest CPI and PCE deflator behavior coupled with a modest, first



increase in the FF rate. However, there is also a non-zero probability that the inflation barometers will move upward sharply, at which point bond traders will proclaim "the Fed is behind the curve, 1994 déjà vu," and the economy will suffer an interest rate lynching. Part of this is fear and part is the reality that the economy is doing well. Both are responsible for the steady uptake of middle and long ends of the curve over the past two months. But, the equity destruction going on this week may not be based entirely on bond market blues. Since 9:30 AM today, when equities opened, bond value destruction has been modest while equities were pummeled. While we do believe that the Bond Market "gets it" before the Equity Market, it would seem that Equity Traders have something in addition in mind. The graphs above are suggestive that it was not pressure on bonds that moved equities downward with such virulence today. Equity traders have been running down the market as well but this morning's decline seemed to have a momentum of its own.

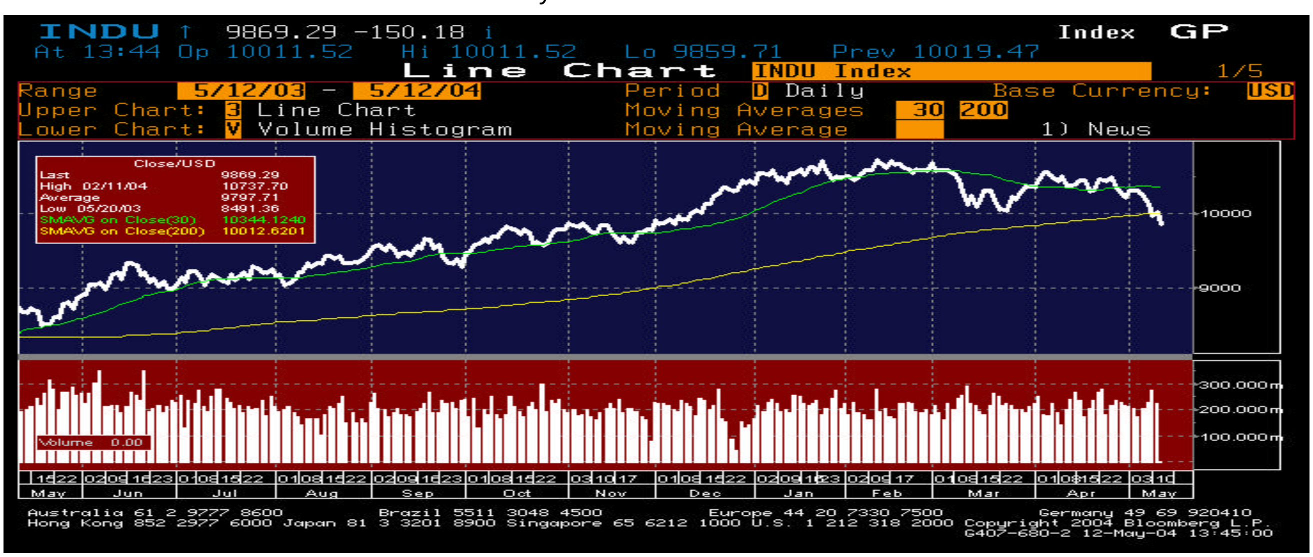
For weeks, equity traders have had the chance to sell the equities based upon an outlier, inflation dominated, Fed script of accelerated interest rate rises. While rates at the middle and long end of the curve are up as much as 75 basis points that is not quite a lynching. That path, however, has to be measured against the appearance of steadily improving corporate profits and the likelihood that SH2004 maybe as good, or perhaps even better than the FH2004. So what is driving equities now well below their 200-day moving averages? Who makes up the cast of "all the usual suspects," in this scenario?

Several of the "usual suspects" are probably "**asset allocation trades**" that are forcing some investors out of equities and into bonds or even cash (even with the risk that the bond market has underpriced an ultimate Fed pace that turns out to be far from 'measured.'). Another candidate is that oil is now over $40 with no real prospects that the high prices will normalize soon, and with oil coupled to the unceasingly unfavorable geopolitical news.

And, certainly, we cannot eliminate from the suspect list a new Bear Market. In that case, the last wish to be first, and equity holders are rushing for the exits. Out with equities; out with bonds a bit and hold cash even at 1%? We did see it in Japan in the not so distant past.

The odd thing about that kind of analysis is its self-fulfilling prophecy characteristics in which a collapse in equities, pulls down housing, and ultimately slows growth far below the consensus 4/4.5% real growth forecast. If that is true, what will force prices upward and why would the Fed then continue to tighten?

No one ever told us that this would be easy.



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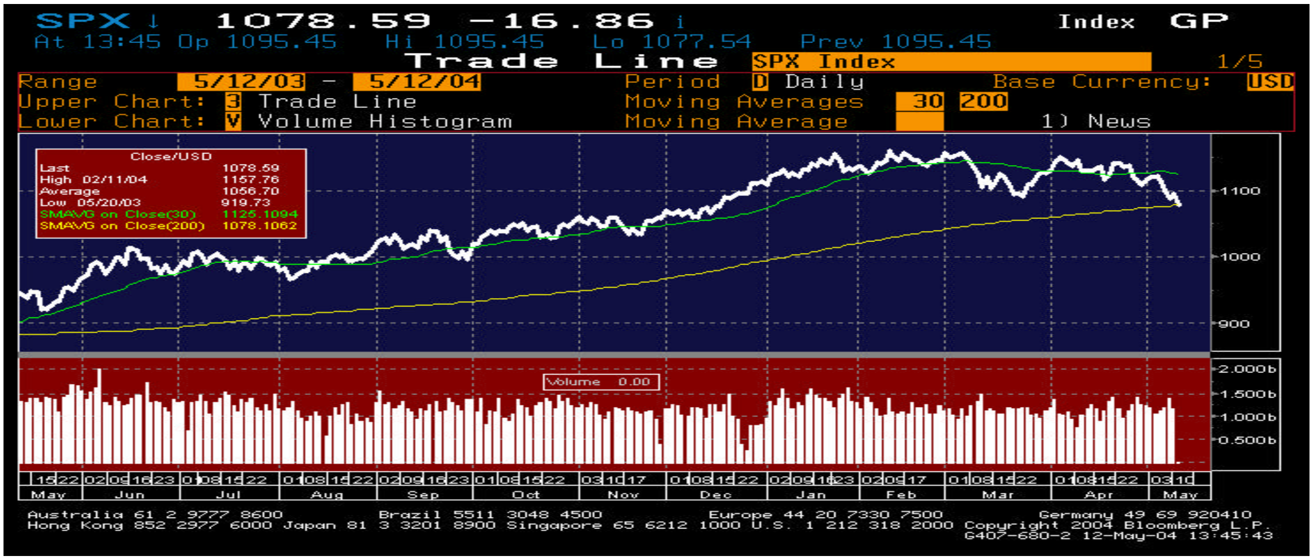

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