Is This Bull Unstoppable?

Posted: 2/28/2011 by Jurrien Timmer

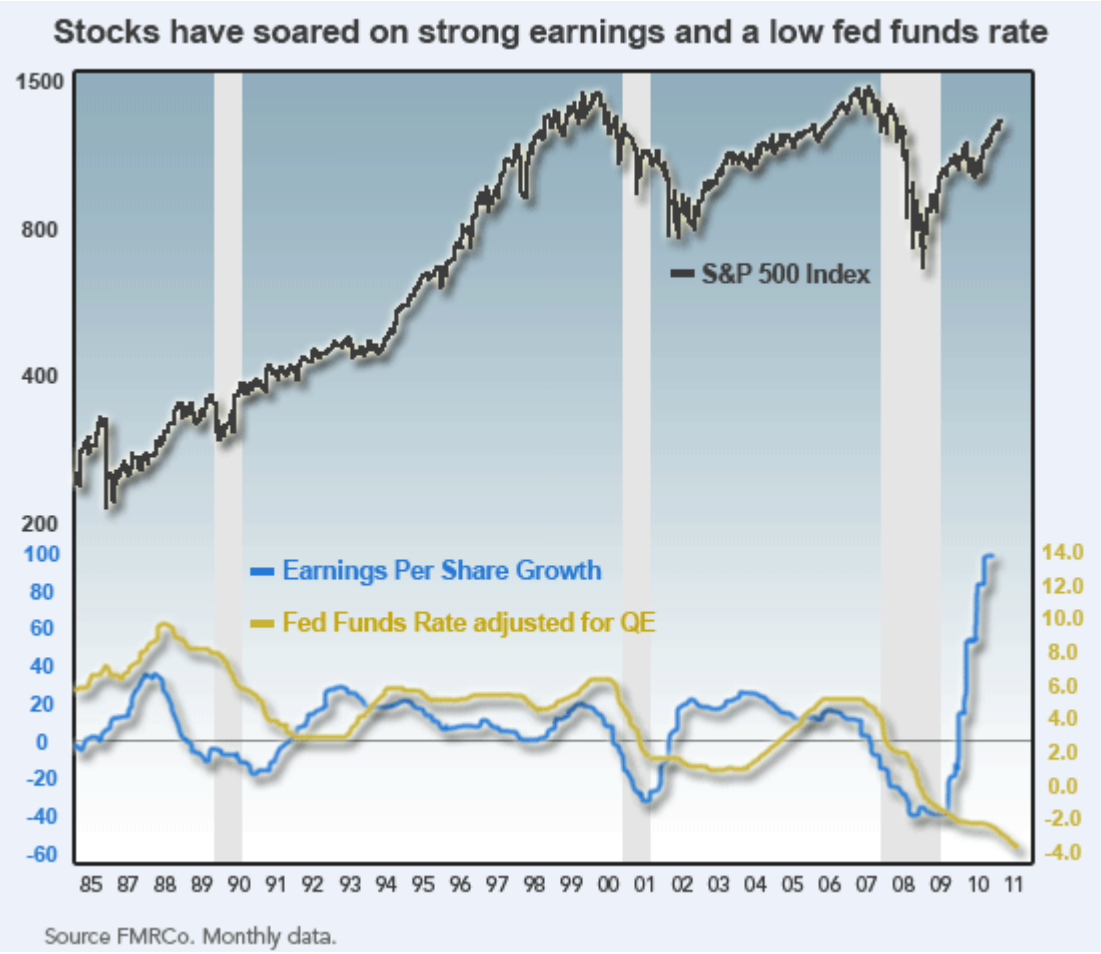
The key is how—and when—the Fed exits its historic stimulus program.

Can anything kill this bull market? It does not appear so. A huge spike in Treasury yields? Yawn. Out of control food prices? Not a factor. Riots in Egypt? Nope. Technical divergences? Not interested. Or so it seems as I watch the stock market continue to go up.

What is clear is that this incredible rally since late August seems to me to be about one thing and one thing only: a flood of liquidity. There's the Fed's liquidity through the Fed's second phase of quantitative easing (QE2), and now there is investor liquidity through fund flows that have come out of bonds and emerging markets funds. And, of course, the technical fundamentals haven't been bad either, making it plausible to me that U.S. stocks may keep going up in the near term.

I believe it is becoming increasingly clear that stocks are following the playbook of an inflationary boom. The Institute for Supply Management's (ISM) January 2011 manufacturing survey is the highest in years, earnings are strong, and now money supply growth is picking up steam. Ultimately, I fear this inflationary boom scenario may be followed by an inflationary bust (or stagflation), but perhaps that day is farther away than I have been anticipating.

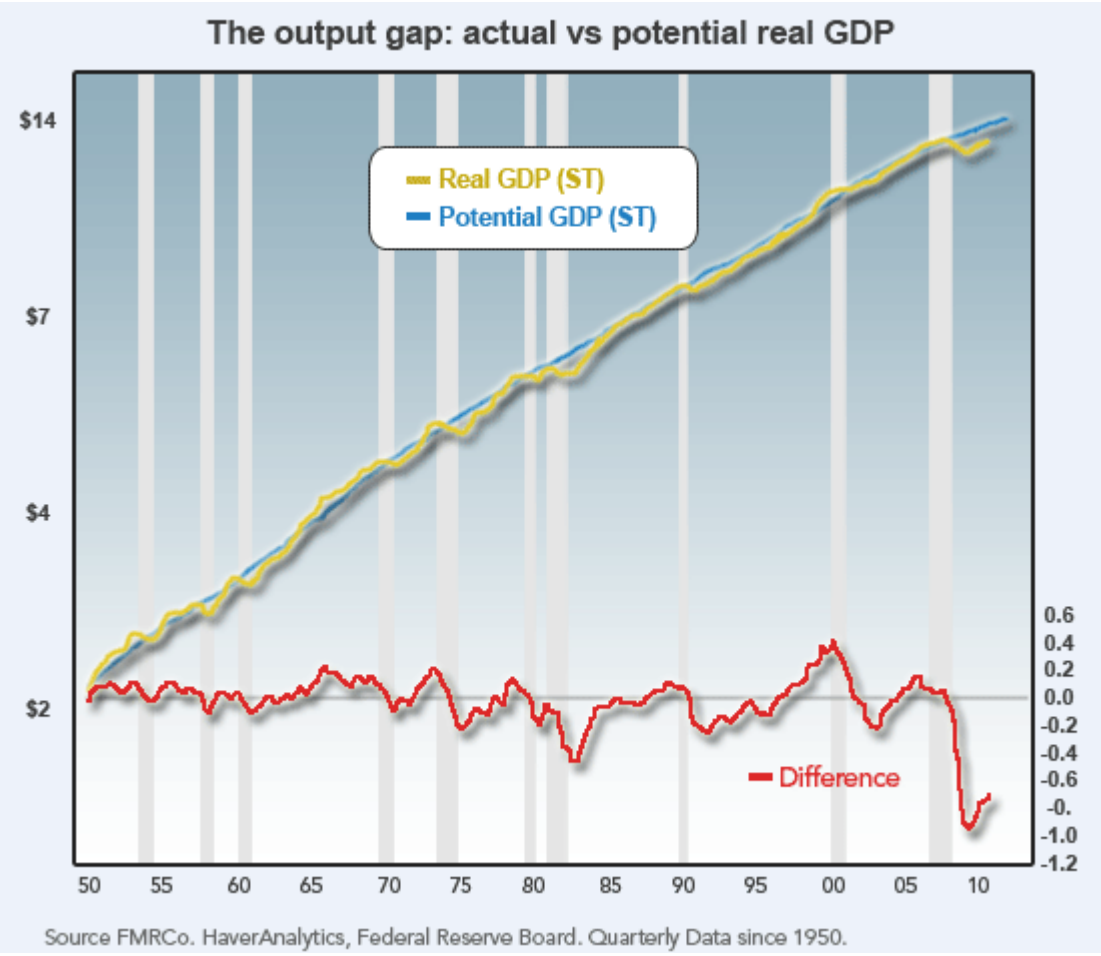
For now, the Fed continues to pump hundreds of billions of dollars into the market, while at the same time corporate earnings are booming. The chart below shows how earnings growth is accelerating while, at the same time, the Fed funds rate (adjusted for QE)* is still going down, further and further below zero. From my perspective, it's no wonder stocks are flying.



Thoughts on stocks, gold, and the dollar

In terms of trying to pick a top in stocks, the only thing we know (sort of) is that QE2 will end in June and, at this point, it appears to me unlikely that the Fed will have the justification to start QE3. This leads me to believe the Fed and the European Central Bank may remain easier for longer than was feared, which I believe is good for nominal stock prices as well as gold. However, it may not be so good for the dollar.

But, I have to hand it to the Fed. I believe QE2 is working like a charm when it comes to lifting equity prices—and may also be contributing to the rise in commodity prices. And, despite favorable economic news, it's hard for me to see the Fed raising rates anytime soon. Take a look at the chart below that shows real gross domestic product (GDP) versus potential real GDP. The gap between the two remains enormous—at $1 trillion—and appears to justify the Fed's output gap theory, or the difference between the economy's actual and potential output. An output gap suggests that the economy has a large amount of slack in the form of spare capacity and labor, which means that inflation is not likely to become an issue. For me, this makes it that much more likely that the Fed's zero interest rate policy (ZIRP) will remain in place for some time to come, even if QE2 ends in June.



Fed exit strategy is key

With the economy getting better and inflation around the world heating up, the logical question for investors is when and how the Fed will exit its unprecedented program of ZIRP + QE. I fear that the Fed may stay easy too long, focusing on an outdated measure of inflation, and leading the U.S. to an inflation problem in the future.

Whenever Fed Chairman Ben Bernanke is testifying before Congress or making speeches, he generally defends QE2 by pointing out how low core inflation is and how high unemployment is. Hence, the Fed's dual mandate on full employment and price stability is met through ZIRP and QE. Fair enough, but is inflation really that low?

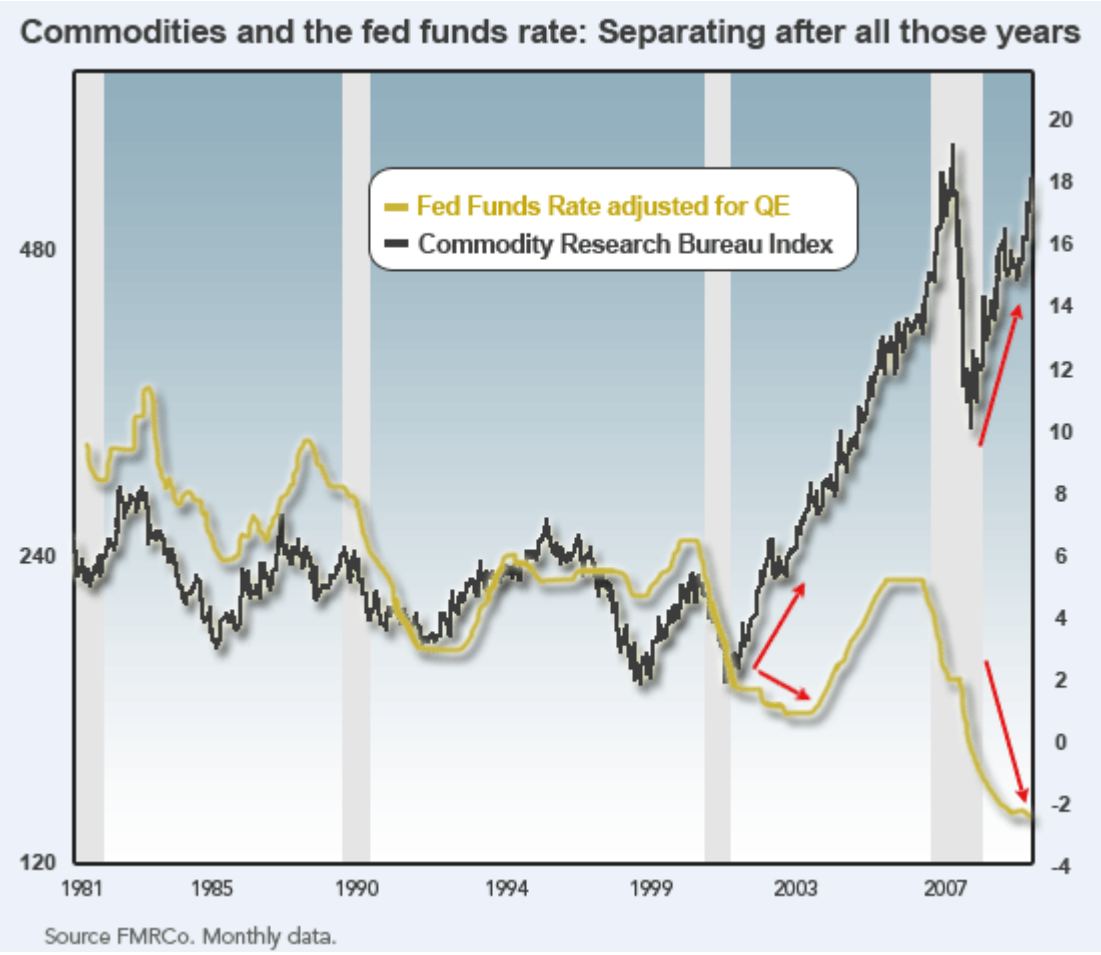
The Fed has always (rightfully) defended its focus on core inflation by saying that food and energy prices are highly volatile, and tend to swing up and down more so than other forms of inflation (wages, rents, etc). This has historically been the case, and ultimately headline inflation has tended to catch up to core inflation, validating the focus on core inflation.

But is this still the right approach? It remains to be seen. Food and energy prices have moved sharply higher in recent months and appear to be trending higher rather than mean-reverting. If this remains the case, I believe the Fed could misstep by focusing on core inflation rather than the perhaps more relevant headline inflation. After all, for most of the world, food and energy inflation are critical matters.

Back in 2008, when food and energy prices exploded, the annual change in the core Consumer Price Index (excluding food and energy) hit 5.35%. This could easily happen again. The Fed will have to hope that it is another temporary spike and that food and energy prices mean-revert back to core inflation. If not, it may find itself behind the curve. If so, I believe this could be bearish for Treasuries and the dollar, and good for inflation hedges like energy stocks and commodities.

What it means for stocks, however, is unclear. To me, stocks appear to be behaving as if we are already in an inflationary boom, and perhaps we are. But, eventually, I think higher input costs will either stunt consumer demand or put pressure on profit margins. The question is how much longer before this happens? In other words, when does an inflationary boom turn into stagflation?

One way to look at the divergence between monetary policy and commodity prices is in the chart below. You can clearly see the historical correlation between Fed policy and input prices, but in recent years that correlation has broken down. Currently the Fed funds rate (adjusted for QE) is at -3% and declining, while commodity prices are climbing to new highs. How long can this go on before the "rubber band snaps," either by commodities plunging in a deflationary crash (like in 2008) or the Fed being forced (by the bond market) to tighten and thereby undermine the recovery? Or what if the Fed does nothing and the dollar falls further and sends inflationary expectations skyward?



I don't mean to be critical of the Fed. One could easily argue that it had no choice but to implement QE1 and QE2. But I believe the Fed could find itself in a real bind if inflation picks up in the months ahead. Without more QE, I believe we could risk a deflationary relapse like the one we had in 2008. But if the Fed stays too easy, either by doing more QE or keeping rates too low, we risk an inflation problem, which would likely lead to higher yields and a weaker dollar. I think the great hope is that the economic recovery (and therefore the bull market in stocks) becomes self-sustaining and is no longer dependent on the Fed's medication. This could happen, but the fact remains that, since 2009, the stock market has only gone up when the Fed has pumped money into the system.

For now, stocks are enjoying the ride, but eventually I suspect the Fed's twin mandates of full employment and price stability may be in direct conflict which each other. With the Fed focused on what I would consider an obsolete inflation metric, I believe the chance of a misstep is high.

* The Federal Reserve calculation is such: every $500 billion in quantitative easing is the equivalent of lowering the Fed funds rate by 75 basis points.

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