INTEREST RATE CUTS VERSUS INFLATION…WINNER TAKE ALL?

It is amazing that in the midst of a cataclysmic housing bust, many commentators are fretting about the return of inflation. As we have been writing since the start of 2007, inflation concerns are seriously misplaced in terms of the outlook for the next year. The bursting of asset bubbles and seizures in the credit markets are profoundly deflationary events. Yes, the resulting policy reflation may sow the seeds for renewed inflation down the road, but there is a dynamic that must play out before we have to worry about that: first the economy must re-accelerate and then overheat.

The stock market's positive response to the Fed's rate cut does fit well with the experience of the past few decades. Lower rates typically lead to higher multiples and that more than offsets weaker earnings prospects. But there is a caveat. In the past, before rates started to fall, equities have usually suffered a correction as investors acknowledged deterioration in the earnings outlook. That has not happened in the current cycle – the stock market has only suffered minor and short-lived corrections during the last 4 1/2 years, with no decline exceeding 10%.

We continue to have a positive bias toward equities, even though volatility could be high. The U.S. economy faces challenges in the next few quarters, but it should muddle through. Meanwhile, the low inflation environment will give the Fed room to ease, and the combination of a weak dollar and firm overseas growth will provide important support to earnings.

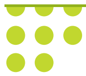
Housing will certainly face a multi-year adjustment. It was an enormous boom, and the usual symmetry as such always suggests a strong bust. It's very clear that house prices are not yet anywhere near a market clearing level. Meanwhile, the overhang of unsold new and existing homes remains extremely high. Only forced sellers are under pressure to mark down home prices. Others are more likely to take their homes off the market until prices firm. That drags out the cycle because it means that any tendency for prices to rise will lead to an increased supply of homes on the market.

The effective shutdown of the subprime mortgage market will also delay the housing recovery by making it difficult for many would-be buyers to obtain needed financing. The authorities have announced some proposals to improve the flow of mortgage credit, but it will take a while to get back to normal. And there will be no return to the excessively-easy lending conditions that were the cause of current subprime problems.

There is considerable uncertainty about the extent to which consumer spending will be affected by the housing downturn. As perceived wealth erodes, there will be pressure on savings rates to rise. However, the main determinant of consumer spending will be the trend in employment and incomes.

The strength of income growth allowed spending to hold firm even as housing sagged, but that support is now eroding. Employment growth has slowed, and that will translate into weaker income growth. Consumer confidence has dropped in response to the labor market deterioration. On a positive note, there does not appear to have any major increase in the pace of job layoffs outside the housing sector, and the employment rate is holding at a historically low level.

Overall, the pace of real consumer spending growth is likely to average between 1% and 2% in the next few quarters. With residential housing continuing to be a drag on activity, the onus will be on capital spending and net trade to prop up growth. Corporate sector finances are strong compared to previous periods of economic weakness, but business confidence has deteriorated, and earnings growth is slowing. Thus, it is not reasonable to expect capital spending to accelerate strongly in the coming year.



The net trade picture is the bright light in the outlook. Export volumes are expanding at three times the pace of imports, helped by a strong global economy and the competitive boost from a weak dollar. Meanwhile, import growth has slowed in response to the softness in domestic demand.

The deceleration in import growth highlights that the global economy is not immune to the effects of U.S. demand. Japan's economy is struggling again, and the European economies are losing some of their solid momentum. However, the emerging world remains strong. The problem in China continues to be the overly rapid growth and most major energy and resource producers are booming against a background of high export prices. Global economic activity also continues to be supported by buoyant liquidity conditions.

The seizure of the commercial paper market has raised fears that the era of buoyant liquidity has run its course, adding to the bearish view of economic and market outlook. The liquidity boom partly reflected easy credit conditions, and that, in turn, was partly a function of confidence and the willingness of lenders to lend and borrowers to borrow. Confidence can evaporate in an instant when there is a financial shock, as has been very apparent in the commercial paper market. All of a sudden, issuers of asset-backed commercial paper found that there were no buyers, and that set off a chain-reaction of problems throughout the money markets.

Although the outstanding volume of the commercial paper market has imploded, there has been a switch into bank finance. The sum of U.S. bank lending plus commercial paper is still growing at around a 10% rate. Also, corporate bond issuance is holding at a relatively high level.

The bottom line is that there is no support to the claim that a serious liquidity squeeze is underway. The commercial paper market still has serious problems, as does the market for subprime mortgages, but there is no overall lack of liquidity that seriously impinges economic activity or asset prices.

The Treasury market did not like the Fed's aggressive rate cut, and the 10-year yield is currently around 30 basis points above its early September low (4.34%), despite generally weak economic data. This market responded to concerns that the Fed is taking risks with inflation, implying increased fears that a stagflationary environment may develop.

A world of low and relatively low and stable inflation does not create an exciting environment for bonds. Assuming inflation nears 2%, then it is reasonable to expect that 10-year Treasuries will spend most of their time fluctuating between 4 and 5 1/2%. Yields will be at the high end of the range when inflation is a concern, and toward the low end when weak growth is the dominant worry.

In conclusion, we have had a positive bias toward the stock market since early 2003, and that remains the case. The combination of a decent global economic backdrop, recent valuations, plentiful liquidity, and what will become more stimulative policy conditions will continue to support equity prices.

Treasuries do not offer much potential for capital gains, absent a slide into recession or an escalation in financial strains. The Treasury market's negative reaction to the Fed's rate cut warns that bonds may not benefit much from additional monetary easing. At the same time, the benign inflation outlook argues against a sustained rise in yields.