Fear Of Fed Cuts

"The important thing is not to stop questioning." -- Albert Einstein

Einstein was the master of the thought experiment; he is said to have conceived special relativity thusly: "I realized that if I was riding on a beam of light, time for me would stop."

He was, alas, a financial neophyte; he said, "The hardest thing in the world to understand is the income tax," so he would have been unlikely to pose the following thought experiment: What if the last week's selloff in stocks was instigated by a fear of further Federal Reserve rate cuts?

Have I spent too much time in the Twilight Zone? No, but I do spend an awful lot of time playing around with economic data and statistical relationships, so let's strap on the old rocket packs and see what lies in the distant reaches of the universe. In space, no one can hear you screaming for the Federal Reserve to cut rates to zero.

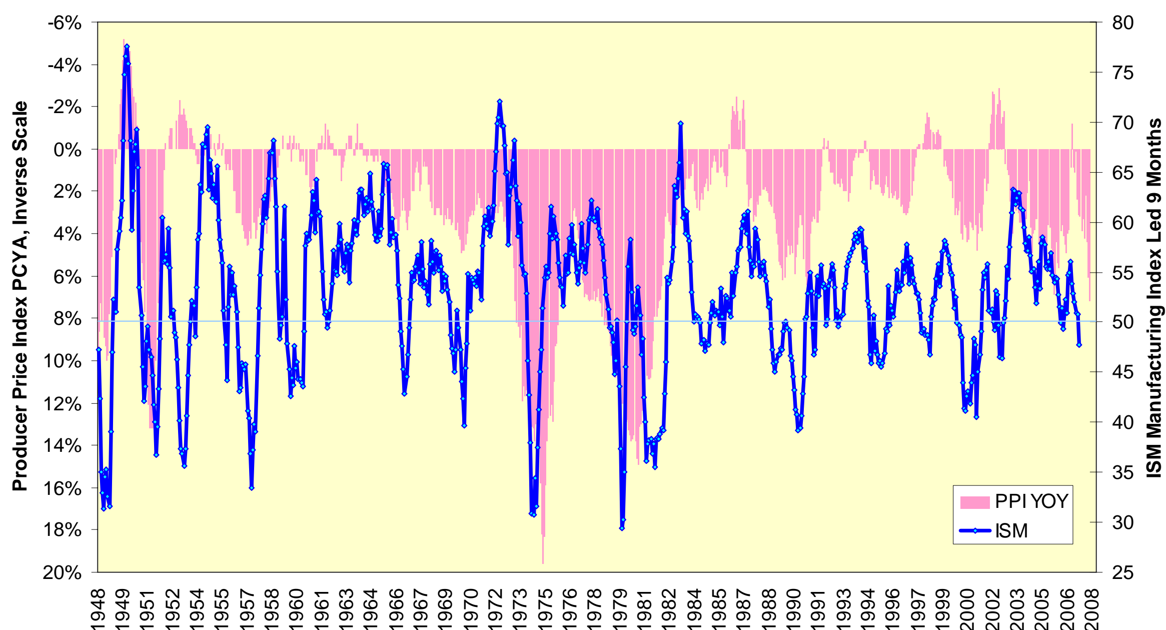
Manufacturing Index

Let's turn the clock back to last Wednesday's release of the Institute of Supply Management's manufacturing index. The reaction in the post-holiday markets was swift: Stocks and the dollar sank, bonds rallied sharply and the federal funds futures market priced in a 24% probability of a 50 basis point cut in the federal funds rate. Oh, and yes, a couple of comedians on the floor of the New York Mercantile Exchange demonstrated why electronic trading has been embraced elsewhere with the juvenile print of $100.00 for February crude oil.

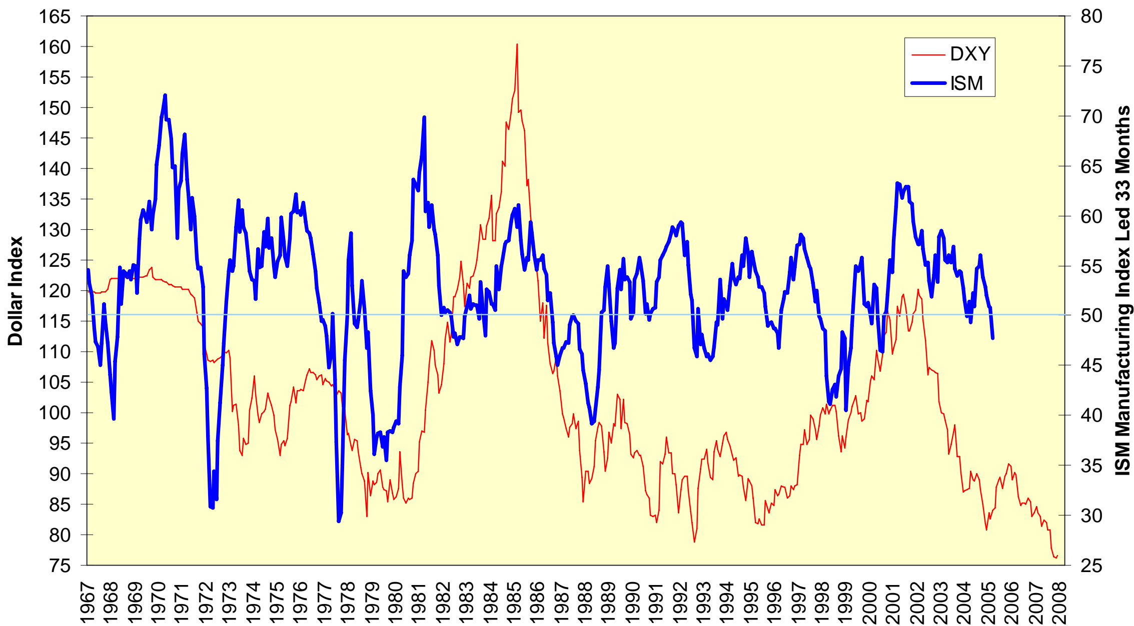
Those capable of connecting two dots gravitated toward the ISM index moving below 50 as the cause of all this, and the number certainly did not help the bullish cause. However, while space is a near-vacuum, financial markets are not. We have been living in a world of rising inflation, and if we accept the argument that inflation is a monetary phenomenon, then the moves by various central banks since last August to relax credit conditions must be a contributor to the inflation picture.

Is there a relationship between inflation as measured by the year-over-year changes in the Producer Price index, plotted inversely, and the ISM index (think, Einstein, would I be asking this if the answer was "no")? For six decades, changes in the PPI have led the ISM index by nine months on average. And the relationship is higher inflation leads to a lower ISM. This is our first piece of evidence the market fears an easing response by the Federal Reserve will exacerbate inflation and make the real economy worse.

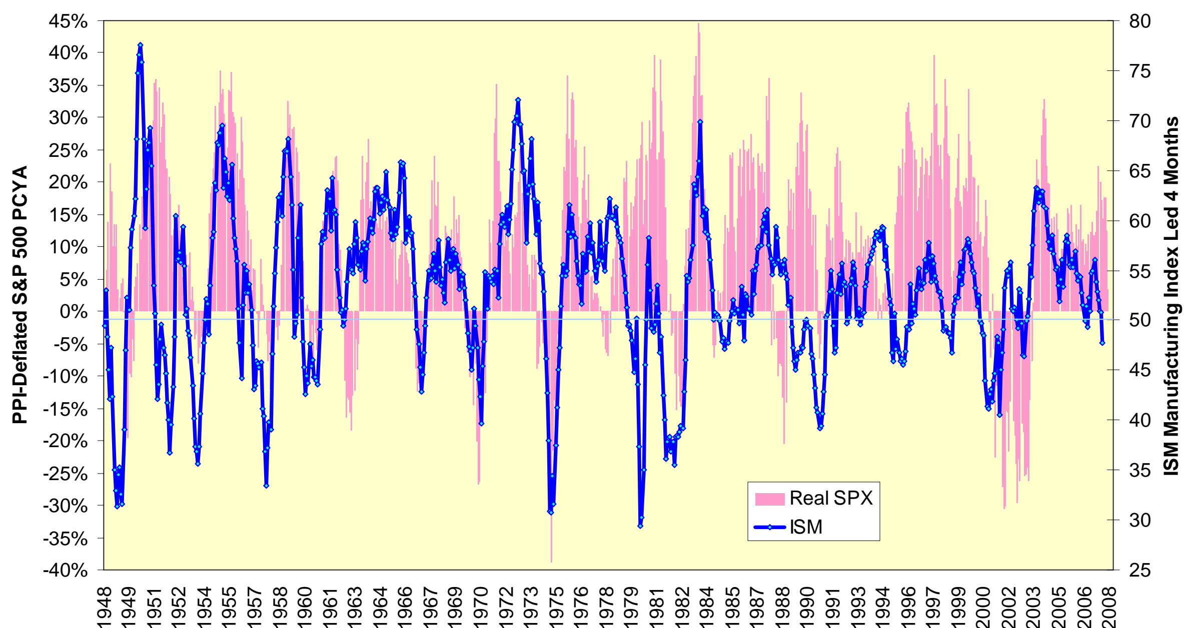
Higher Producer Inflation Leads To Manufacturing Weakness



The Dollar
We do not have as long of a history for the dollar, but the relationship between the dollar index and the ISM index should give pause to all of those who believe in competitive devaluation as a tool for stimulating the manufacturing sector. The dollar has led changes in the ISM index by 33 months on average. A weaker dollar leads weaker manufacturing, and vice-versa. Why U.S. manufacturers continue to believe otherwise might be explained best by experts on addictive behavior.



The Stock Market Connection
Well, you say, the stock market has a few physics tricks up its pinstriped sleeve. It can see into the future, right? Umm, sometimes; we tend to remember the times when stock prices do discount the future and forget those other moments. But here is a case where it works, but not in the direction posited last week. Year-over-year changes in the S&P 500 deflated by the PPI lead the ISM index by four months.

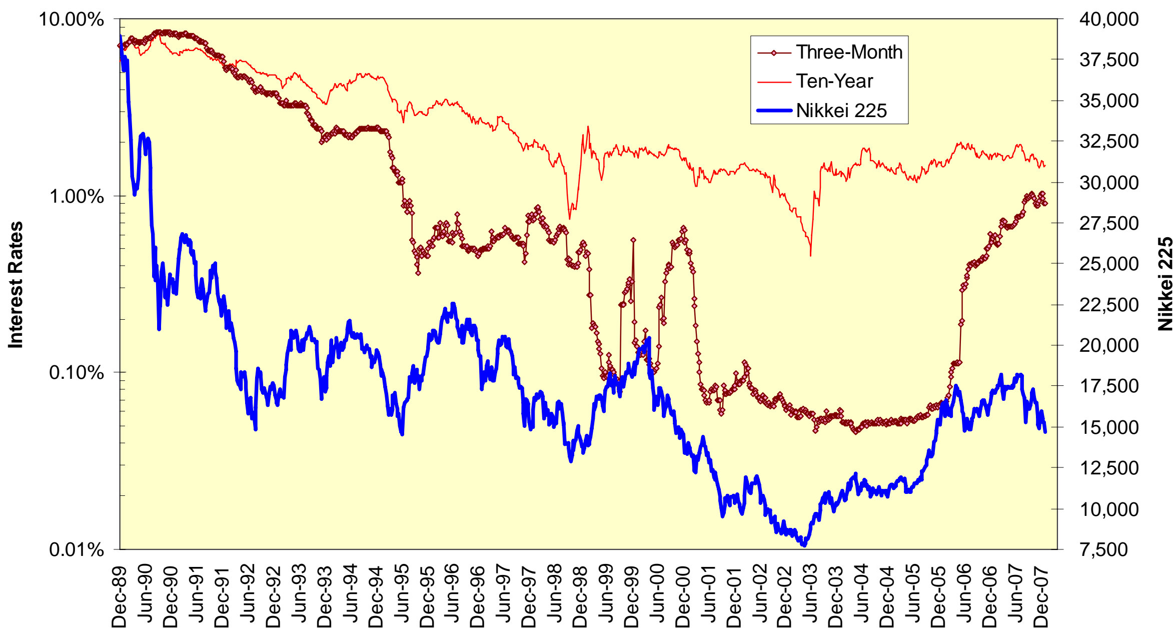


As the real gains for stocks stalled in recent months and certainly took a beating last week, we should rest assured future ISM weakness will follow. Only in the world of quantum mechanics can weirdness such as causing something in the past be permitted; I am sure others will now attribute causation with the proper time arrow. The ISM did not cause stocks to weaken; weak stocks predicted the downturn in the ISM index.

The Japanese Example

King Juan Carlos of Spain provided an international moment of amusement last November when he turned to Hugo Chavez and implored, "Why don't you shut up!" For those of us annoyed by the incessant importuning of the Federal Reserve to cut rates as if that would somehow provide instant relief to all previous credit bubbles caused by too-low rates, we turn to Japan.

The chart below maps three-month yen LIBOR and ten-year Japanese government bond rates from the December 1989 peak of the Nikkei onwards. It is a semilogarithmic scale requiring three cycles. How well has the Nikkei recovered as the result these low rates?



The best thing we can do right now is recognize that after years of trying to solve one bubble by creating another bubble, the game is over. It is time to pay the piper, take our medicine and take one for the team.

And if we can open with Einstein, we can close with a stanza from *Evita*:

> *Instead of government we had a stage*
> *Instead of ideas a prima donna's rage*
> *Instead of help we were given a crowd*
> *She didn't say much but she said it loud*

Don't cry for me, Ben Bernanke.