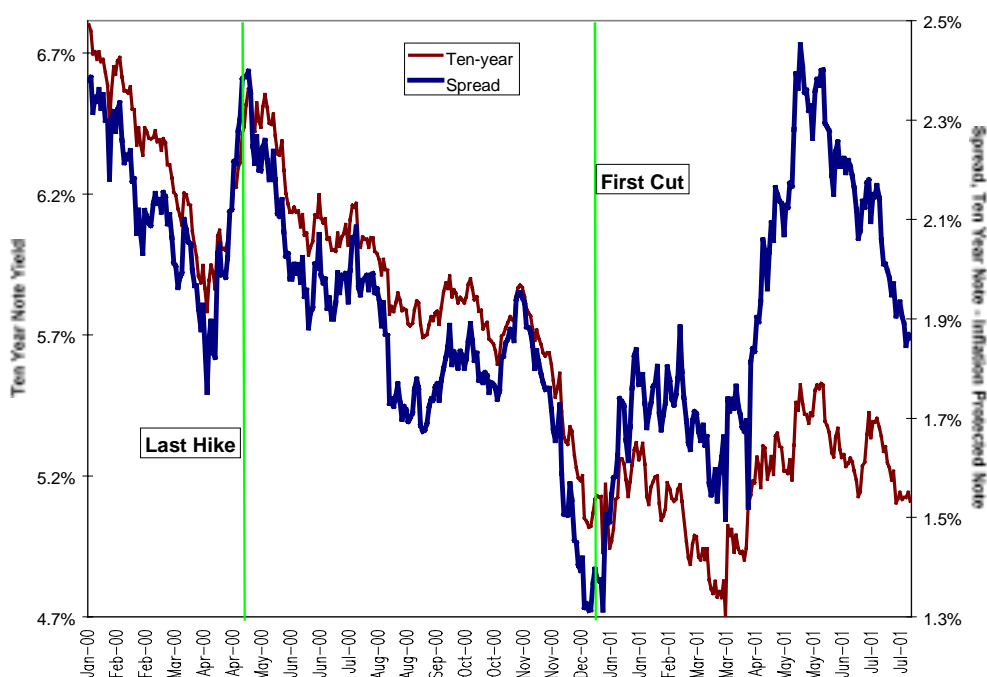


## Economics Through The Looking Glass

OK, class, what's the relationship between the stock market and expected inflation? If you said inflation is the mortal enemy of financial assets, that it destroys bond prices from the long end on in, and that it reduces the quality of earnings to a bad joke and therefore erodes stock valuations, you're so 1970's. We're in a new millennium – personally, I kind of miss 1999 – and we need to go behind the mirror and find out what's really happening.

First, let's loosen up by doing a few Fed bashes for this week. As noted in this space in February, (see "Fear Inflation Now," February 15, 2001) the first 100 basis points of cuts in the federal funds rate produced a widening gap between Ten-year Treasury notes and similar inflation-indexed bonds (TIPS). The conclusion, not unreasonable at the time, was the infusion of money into a slowing economy would produce inflationary pressures. Let's update this inflationary expectation measure and see what it's telling us now.

Ten Year Notes: Yields And Inflationary Expectations

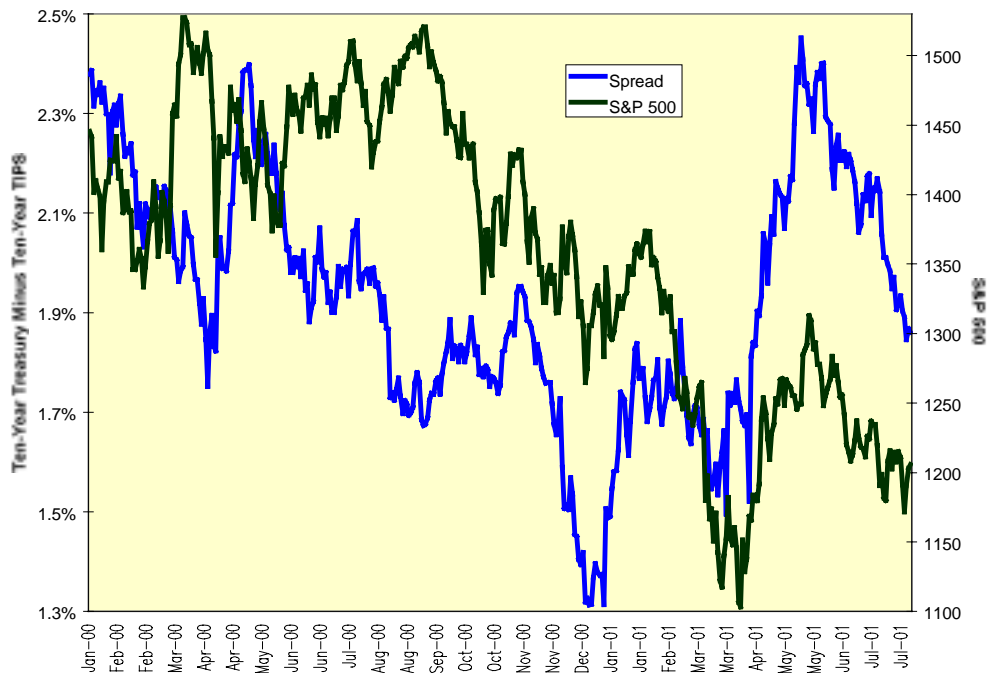


Several items stand out on the chart. Both yields and the inflationary spread jumped going into the Fed's last rate hike in 2000, but soon reversed. Between Election Day and Christmas, the inflation gap at ten years fell 60 basis points, from 1.915% to 1.315%. Interestingly, Alan Greenspan just testified in his Humphrey-Hawkins testimony this was the period when the Fed first became aware of serious problems in the economy. Those of you who believe, still, that the Fed knows more than the rest of us, please note how the market once again got it right first.

Once the Fed started cutting, inflationary expectations shot higher quickly and then dipped as stocks made their March lows. Once stocks recovered after March 22, inflationary expectations really took off; the measure added another 80 basis points in the eight weeks between March 22 and May 15, the time of the Fed's last 50 basis point rate cut. Stocks peaked one week later, the S&P 500 on May 21, and the Nasdaq Composite on May 22.

Most recently, we've seen a plunge in both inflationary expectations – the spread has fallen 60 basis points down to a 1.861% gap between Treasuries and TIPS – and in the stock market. The S&P 500 has fallen over 8% during this period. The counterintuitive relationship between stocks and expected inflation is so surprising that we've included it below for your visual satisfaction.

## Not Supposed To Be: Inflationary Expectations And The S&P 500



### Slow Down, You're Moving Too Fast

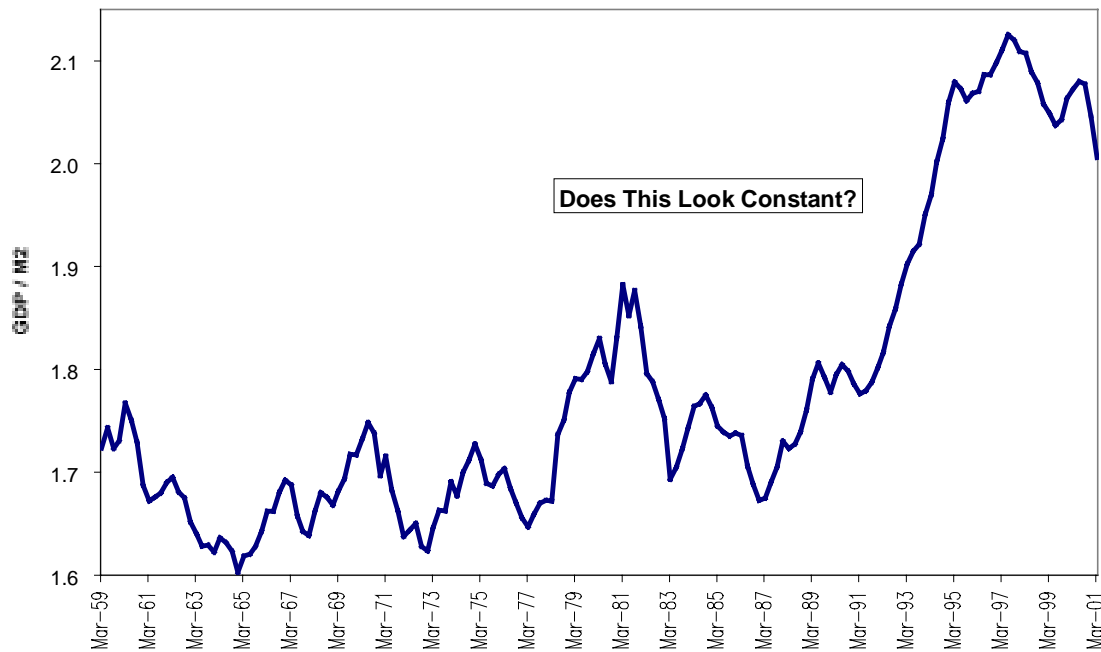
Well, maybe there aren't supposed to be any T-Rex's in New Jersey at this time of year, but what are you going to do about that big lizard making a mess of things in Paramus? Statistical demonstrations to the contrary, it's still unlikely that the stock market is welcoming higher inflation or fearing lower inflation. More likely, the market is continuing to confuse monetary actions with desired outcomes. In this case, monetary largesse was supposed to produce economic acceleration and higher earnings, along with a few other goodies, like a non-overvalued dollar.

Chairman Greenspan reiterated this in his testimony and even took the drastic step, for him, of saying so in simple, declarative sentences. As an aside, I'd like to challenge the nation's comedians to produce a skit of Alan Greenspan trying to order at a McDonalds. I'm sure it would end with the flummoxed kid at the counter stammering "You want fries with that?"

The key to the recent confusion may be found in the alarming datum released in Friday's GDP report that capital spending was at a 19-year low. Lower capital spending inevitably will lead to lower productivity growth, and it was the technology-driven growth of productivity in the 1990's that allowed monetary velocity to accelerate without igniting inflation. Velocity is the ratio of GDP to the money supply.

Monetarists hold velocity to be constant, which allows their fundamental macroeconomic equation,  $[\text{Money} \times \text{Velocity}] = [\text{Price level} \times \text{Transaction volume}]$  to hold. Constant velocity implies that an increase in the money supply without an increase in transactions will increase inflation. If velocity is constant, it's not apparent over the past four decades.

## Velocity of M-2



The present and ongoing fall in monetary velocity implies that the Fed can keep pumping money into the economy without igniting inflation so long as economic activity doesn't take off. And, if growth does resume, we'll have to see growth a big drop in monetary growth rates or a big rise in productivity to avoid inflation.

The dilemma is sickening: Which do we want, slower economic and profit growth or higher inflation the minute growth resumes? The only way we can have both is to return to the 1990's productivity boom, and how's that going to happen with the crash in capital spending? It's all the enemy of financial assets, and that really is so 1970's.