MRA
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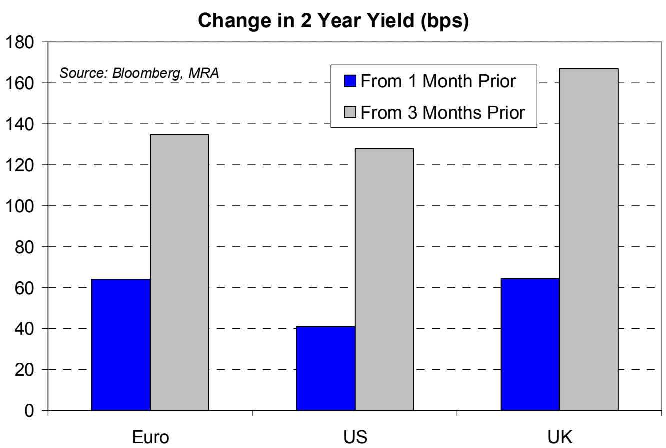
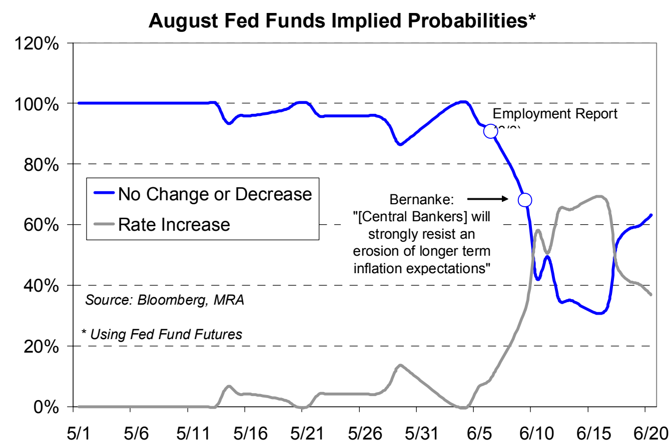
Central Bank Synchronicity

Thesis: In recent weeks while the market has continued to confront the ongoing housing meltdown along with growing evidence that the economy is weakening broadly, inflation has emerged as perhaps the most troublesome variable. Central Banks globally appear synchronized in the view that the risks presented by inflation may call for active policy response. The hawkish rhetoric, if acted on, suggests that tighter monetary policy may ultimately cause economic growth outside of the US to slow. As a result, those stocks that derive a large proportion of their revenue from international sources may encounter a more challenging profit environment. All in all, this development bolsters our bearish stance on the US equity market.

As food and energy prices continue to rise, attention has quickly shifted to the worrisome inflationary trends being experienced globally. While credit market dysfunction continues, investors are shedding government securities they held on a flight-to-quality basis, as they seek refuge from lost purchasing power resulting from inflation. Rates on the short end of the yield curve in major developed markets have backed up substantially in anticipation of tighter Central Bank policy in the not distant future. In the chart below, we show the change in yields on the 2 year portion of the yield curve in the US, UK and ECB. These are substantial moves – for example on March 17, 2008 when JPM assumed Bear Stearns with the Fed's underwriting, 2 year US Treasury yields reached a low of 1.35%. As of June 20, they stand at 2.90%, with a 33bps surge on June 9, following hawkish comments from Bernanke. This day's move was the largest in the 2 year maturity since March 1996 and the largest 5-day increase in yields of any period after the double digit inflation and interest rate period of the early 1980's.





As inflation accelerates, monetary policy, all else equal, becomes looser. In other words, Central Banks are forced to tighten to prevent a de facto ease. Should Central Banks outside of the US embark upon a tightening campaign to fight inflation, it is reasonable to assume that economic growth outside of the US will eventually slow. It is reasonable, as well, to assume that higher rates abroad and the potentially weaker dollar that results, will force the Fed's hand in also tightening. A Fed tightening scenario, while hard to envision given the fragility of the US economic landscape, must be (and has been) priced into the yield curve. Set against the backdrop of the housing crisis and the US election year, the Fed is in an unenviable position. However, Bernanke showed resolve recently when he publicly expressed support for a stronger dollar. At a recent (6/3) IMF Conference, he said, "we are attentive to the implications of changes in the value of the dollar for inflation and inflation expectations and will continue to formulate policy to guard against risks to both parts of our dual mandate, including the risk of an erosion in longer-term inflation expectations." Should other Central Banks start to raise rates, Bernanke will likely need to follow if his support for a strong dollar is sincere. On a very macro level, the Fed sought to ease the burden of borrowers in the housing crisis through an inflation tax. The route in the dollar and the corresponding stoking of inflationary pressures experienced globally jeopardizes the Fed's ability to continue to impose this tax.

The inflation related headlines have been constant and the comments from policy makers suggest to us that there is strong consensus that should upward price pressures persist, Central Bankers stand ready to act. In the past few weeks, here are headlines we observed.

Date	Central Bank	Name	Comment
6/20	ECB	Juergen Stark	The ECB "will do everything necessary" to anchor inflation expectations around the bank's 2% limit. ``Risks to price stability have increased'' and the bank is ``in a state of heightened alertness."
6/17	Luxembourg / ECB Council Member	Yves Mersch	“The absolute priority is the solid anchoring of inflation expectations in the medium- and long-term.'' The ECB ``remains firmly determined to prevent second-round effects and the appearance of upside risks to medium-term price stability."
6/20	PBoC	Zhou Xiaochuan	“Surely higher energy prices will send some pressure to the consumer price index, so we may have stronger policies against inflation.”
6/10	Bank of Canada	Mark Carney	BoC Statement: ”Inflation risks have “shifted to the upside”. ``The Bank now judges that the current stance of monetary policy is appropriately accommodative to bring aggregate demand and supply into balance and to achieve the 2 percent inflation target.”
6/9	FOMC	Donald Kohn	``It is very important to ensure that policy actions anchor inflation expectations". ``Some have suggested that the price of oil is on a more significant upward trend than currently appreciated.” ``This tendency for higher overall inflation could risk a rise in inflation expectations."
6/9	FOMC	Ben Bernanke	Policy makers will “strongly resist an erosion of longer term inflation expectations.” ``Inflation has remained high, largely reflecting sharp increases in the prices of globally traded commodities,''
6/5	ECB	Jean-Claude Trichet	"It is not excluded that, after having carefully examined the situation, that we could decide to move our rates a small amount in our next meeting in order to secure the solid anchoring of inflation expectations,"
6/5	BoE	Meeting Minutes	The Monetary Policy Committee, led by Governor Mervyn King, voted 8-1 to keep the benchmark rate at 5 percent this month, minutes of the June 5 decision showed
5/19-20	BoJ	Meeting Minutes	Japan faces ``considerable downside risks including uncertainty regarding future developments in overseas economies and global financial markets,'' ``Inflation risks had been heightening worldwide given the high international commodity prices."

Source: Bloomberg

The recent comments from Nigel Lawson, Former UK Chancellor of the Exchequer are perhaps most telling about the limited degree of flexibility that Bernanke may have. Lawson said, “The Bank of England has been very cautious and careful and it has been much closer to the views of the European Central Bank. It has not gone conspicuously the way of the Fed, where I suspect that Mr. Bernanke's now regretting it''. Translated, "*we are frustrated by the inflation we've been forced to import via the Fed's loose policy and resulting dollar weakness*". Lawson goes on to add, ``Most of the central banks are very, very clear on just how dangerous it is to let inflationary expectations get out of hand.” If other prominent policy makers echo this sentiment, the Fed may find it difficult to hold short term rates at these levels should other central banks raise theirs.

In the table on the following page, we provide an economic overview for major countries around the world (Bloomberg page ECMX). Note that the simple average year over year CPI inflation rate among the countries profiled is 4.1%. Of concern, however, is that the average Central Bank rate is just 4.0%, rendering real interest rates at roughly zero. Using the last 3 months of CPI data, average annualized inflation is 5.9%, leaving real interest rates considerably negative. Central Bankers are unlikely to permit this to persist. All of this is cause to watch the inflation data closely, especially outside of the US, given the comments Bernanke made publicly about the dollar and the implied pressure that Central Banks abroad may be exerting on the Fed.

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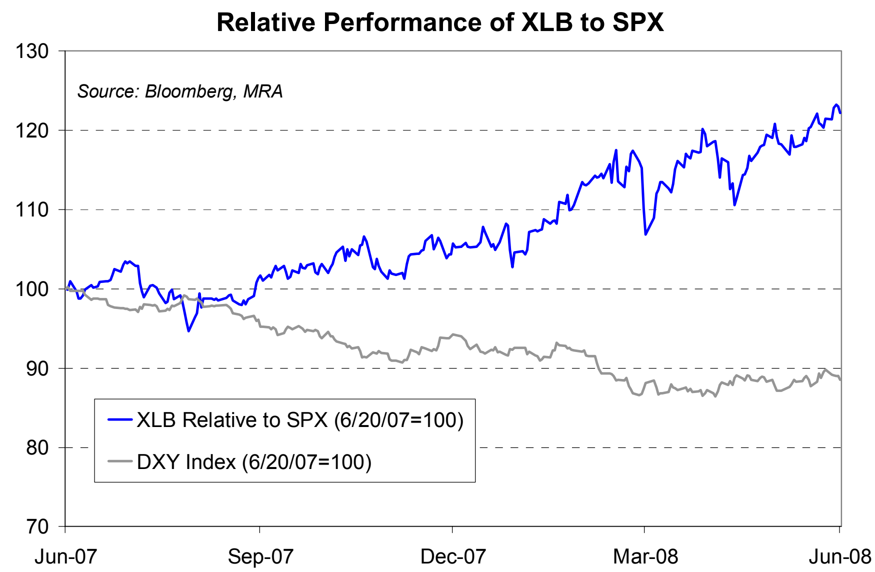
	Real GDP YoY	CPI YoY	CPI 3 Mo Annualized	PPI YoY	Unemployment Rate	Central Bank Rate
Australia	3.6%	4.2%	5.4%	6.9%	4.3%	7.3%
Belgium	2.2%	5.2%	7.7%	9.5%	6.8%	4.0%
Canada	1.7%	2.2%	8.8%	1.0%	6.1%	3.0%
China	10.6%	7.7%	-4.0%	N.A.	N.A.	7.5%
Germany	2.6%	3.0%	3.4%	5.9%	7.9%	4.0%
France	2.2%	3.3%	7.3%	5.4%	8.0%	4.0%
United Kingdom	2.5%	3.3%	7.7%	8.9%	5.3%	5.0%
Italy	0.3%	3.6%	11.5%	6.3%	6.5%	4.0%
Japan	1.3%	0.8%	0.8%	N.A.	4.0%	0.5%
Netherlands	3.1%	2.3%	7.1%	5.7%	4.0%	4.0%
Sweden	2.3%	4.0%	7.5%	2.9%	5.6%	4.3%
Singapore	6.7%	7.5%	6.8%	N.A.	2.0%	0.4%
United States	2.5%	4.2%	4.9%	7.2%	5.5%	2.0%
India	8.8%	6.0%	7.9%	11.1%	N.A.	6.0%
Average	**3.6%**	**4.1%**	**5.9%**	**6.4%**	**5.5%**	**4.0%**

Source: Bloomberg, MRA

In the US equity market, while financial and consumer-oriented sectors have suffered, other areas have fared better. For example, those stocks for which overseas revenue is a significant portion of total revenue have held up well. In the graph below, we show the relative performance of the XLB (materials ETF) versus the SPX over the past year. The XLB has outpaced the SPX by 20% in the last year driven largely by the favorable exposure this group has to economic conditions abroad. Based on data from Bloomberg (PGEO page), members of the XLB derive approximately 50% of their revenue from overseas. This has coincided with dollar weakness, which of course, makes multinationals more competitive in pricing.



If foreign Central Banks apply the monetary brakes and slow economic growth, stocks which had previously benefited from exposure to the strong economic growth that persisted outside the US (even as the US slowed) may see profit declines. While this bearish scenario is conditioned on several steps, the unified rhetoric from Central Banks underpins its potential. As a result, we grow more bearish on the broad equity market. We view inflation as a new, prominent player in the macro landscape that may force policymakers to pursue strategies that slow economic growth at a very fragile time. The result: a tougher environment to generate profits and lower equity prices.

~ Dean Curnutt