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THE FED DEALS WITH ITS PRIOR CHAIRMAN'S MESS

"In the whole history of the world no one has ever washed a rental car."
Lawrence Summers

I was initially disappointed that the Fed cut rates. It seemed to me to bail out bad businesses, foolish homeowners and the stock market. Pouring cheap money into a system already awash (money growth of more than 10% annually) let a lot of sub prime lenders and Mr. Greenspan, who created this mess (one of two he authored) duck the ax that should have fallen. In Britain, monetary authorities let Northern Rock Bank nearly fail before cutting rates and achieved the effect they wanted: "We won't bail out poorly run businesses so take heed." They get it.

That said, I was not surprised to see how most commentators were also conflicted – not to cut and let the economy self-correct or cut and bail out marginal banks while also adding to the risk of inflation returning.

We have come to find out, though, that this mid-cycle slowdown has some small chance of getting worse – of becoming a recession. Given the weakening economy versus financial crises of one kind or another, the Fed elected to eliminate any chance of recession and accepted that the other risk – inflation – was small. It seems to be working and makes sense given the sub prime mess.

I'm not in the recession camp. Some 30% of the world economy is growing at 3 times the U. S. rate and these developing economies – Africa, Asia, Latin America and Eastern Europe – provide more than 80% of all the labor in the world. In some writings, now nearly a decade ago, I hammered on the point that labor is, was, and will be in oversupply for decades to come. This alone drives the price of goods down – globally. Goods inflation – save for luxury goods – is highly unlikely. People who can afford luxury goods will buy them – but broadly speaking, the cost of manufacturing, and thus prices, continue to fall – while profits rise on increased volumes.

The same is not true for materials used in producing all of these goods. We've all seen what China has done to the copper, aluminum, etc. markets.

This cocktail of too much money, too much labor and lagging demand will keep inflation under control for now. This is how I think the Fed reasoned it. It is possible to have pockets of inflation – usually on a localized, cyclical basis – like house prices in Las Vegas – while less virulent inflation – like house prices generally or nationally – remain tame. Put another way, broad excess demand chasing too few goods is not the issue – and that's the classical definition of inflation.

And what of gas? Or food? Or medical costs? Like Las Vegas, these markets correct: We drive less, actually buy and clean our vegetables instead of demanding they be precooked and watch as new businesses arrive to meet out-of-control medical costs – or worse – the government steps in.

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Ed Hyman makes the case that every tightening cycle by the Fed spawned a financial crisis of some sort – the S & L crisis, the NASDAQ collapse, Continental Illinois. Some led to a recession, some did not. In the current case, he notes, interest rates are low, inflation is not a threat, economies globally are doing well, unemployment is very low, profits are strong, money is available, the low dollar is making our goods very competitive over seas and the Fed is easing. Ed notes that no one argument is key – it's the combination that argues against the recession theory.

Yes, there are weak sectors and housing is the worst. It will slow our growth and it will slow consumer spending. Confidence by both business and consumers is waning. The Fed eased, in hindsight, just in time.

Speaking of a slowdown, I expect commodity prices to temporarily ease – a cyclical ease – within a long-term (secular) up trend. Gold is a good example: Ahead of itself because of inflation talk, it should ease down shortly, but the secular trend is up. Should you wish to buy – use Canadian Maple Leafs or Krugerrands – easily bought and sold, widely recognized and no, that's not a suggestion to buy or sell – it's an example.

But we seem to be bottoming. I believe a major credit crisis has been avoided and that leaves housing. Locally, we are watching crowds of buyers show up at foreclosure sales – we have too few houses for the population. Detroit, by way of the other extreme, has housing for over 1.8 million and a population half that (thanks to Jim Grant for that tidbit).

The issue we'll need to face for a long time to come is that the world – especially the emerging countries – will continue to grow far faster than the United States. Their markets are strong – some slowing here and there (in major G7 countries), but overall faster elsewhere. That will keep the dollar weak and help exporters here in the U. S. I am not surprised to see parity now between the U. S. dollar and the Canadian dollar. . . our northern neighbor did a better job with their budget.

So what to do? Well, my clients remain significantly exposed to developed and developing countries. Excess money globally is being put into even more factories, stores, etc. For many of these fast-growing economies, the labor force averages about $5 per hour (ISI Research). What they buy (materials) they inflate, what they sell they deflate. Logically, then, staying well exposed to oil is one idea and maybe some commodity funds when the next cooling off occurs. High-end retail continues to intrigue me as do the auto stocks – but not yet. Ethanol is facing the morning after its binge so that's a pass – and I believe solar will matter far more than wind for future energy sources.

Last – watch Iraq. I think the smart money sees an end – the currency is up strongly, we are in essence backing the national debt and Iraqi businessmen are meeting in Finland to discuss – well – what businessmen of different religions discuss – money of course. As always, follow the money.

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For the markets I see more volatility well into next year. The primary two reasons will be housing shocks yet to come (the peak month for ARM to hit is March 2008 – some 2 years after the peak month of acquisition) and investor disenchantment with both 3rd and 4th quarter earnings. They'll be okay – positive numbers – but not like the last 3 years or so – just smaller rates of change. This seems likely to me because productivity has about peaked. It was a good 8-year run, but future big gains seem limited.

And what of the rental car quote (or paraphrase – I can't find the original)? Well, it seems to me that as housing continues to fall and banks become really concerned that they have too much to take big hits on, they'll start renting to cover exposure <u>or</u> speculative buyers will come in and rent the properties. Having been a landlord I know how renters treat their homes or apartments – pretty much the way the last car you rented looked/smelled/drove. So, long term, yet another devaluation of housing stock – mostly at the low end. Larry Summers was the guy, by the way, that the ladies on Harvard's faculty ran off . . . a very insightful economist and worth reading. I also recommend reading Thomas Sowell.

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