

# BARRON'S

THE DOW JONES BUSINESS AND FINANCIAL WEEKLY

www.barrons.com

FEBRUARY 7, 2005 \$4.00

*Stagflation leads this iconoclast to both gold and Treasury notes*

## Handling the Truth

**An Interview with Stephanie Pomboy** • One read of her MacroMavens commentary and you're liable to be hooked. Stephanie's iconoclastic takes on the big picture are consistently provocative, perceptive, and on the money most of the time, as well as just a great read. Stephanie, who worked with Ed Hyman and Nancy Lazar at ISI Group for 11 years, set up her own shop in 2002, and has attracted an elite list of institutional clients.

They've been on the receiving end of some distinctly contrarian calls—such as her call to buy Treasury bonds in the face of Fed tightening.

She also remains a fan of gold and gold stocks (especially South Africa's), which may be in her genes: The 36-year-old's dad, Richard Pomboy, put forth his bullish views on the metal in *Barron's* back in the 'Nineties.

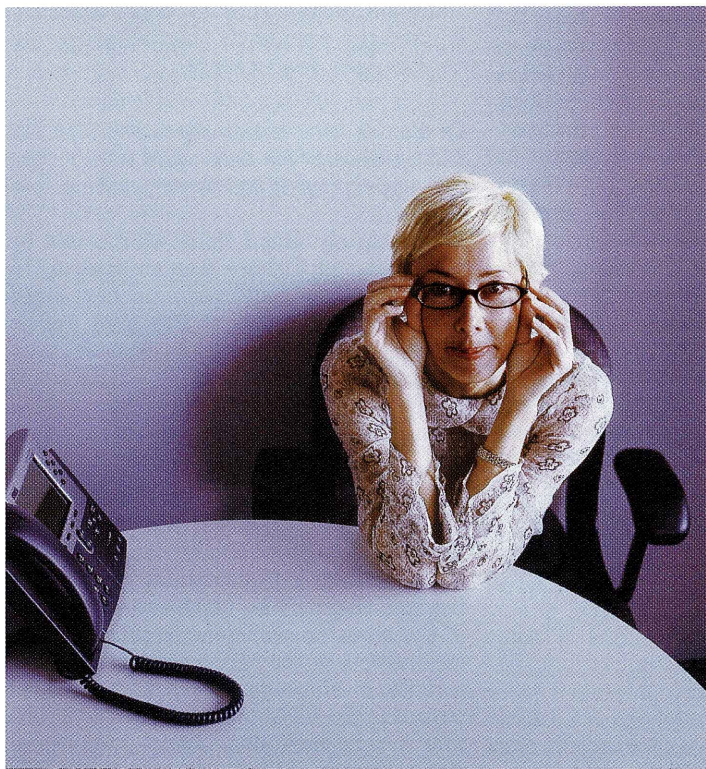
With a black belt in Tae Kwon Do, Stephanie Pomboy thinks and goes her own way, which is apparent from our recent conversation.

— Jennifer Ablan

**Barron's:** *Is this year going to be a replay of '04 for the economy?*

**Pomboy:** I see an environment of stagflation [tepid growth combined with relatively high unemployment and rising prices] with low interest rates. It sounds like an oxymoron to most people and yet I think that's a fairly apt description of what we have already been through over the last year. The surprise in 2005 will be that stagflationary pressures intensify and yet rates remain relatively stable.

**Q:** *Last week, the Fed said again that future hikes likely would be measured.*



**A:** Yes, and while I expect them to call it quits sooner than most, when I speak of

pressures as well. So you have this combination of higher import prices and higher

stable rates, I'm really thinking of long-dated Treasuries—the 10-year note and the 30-year.

**Q:** *But bond bull markets are associated with disinflation [a slow-down in the rate at which prices increase], not stagflation.*

**A:** Well, the forces of stagflation are fairly evident. One is that we've got a combination of a dollar bear market, which is obviously fueling higher import prices. At the same time, we have a commodity bull market, which in my view is feeding input price pres-

Ken Schles for Barron's

(over please)



input prices, and very little ability to pass those prices on because consumer-income growth has been so lackluster, notwithstanding the Microsoft dividend payment, of course!

What I look at very closely is wages as a share of income, because increasingly, benefits—health care in particular—have become a larger and larger share of income and obviously you can't fill your tank or buy your groceries with your health-care benefits. So actual wage and salary growth have been very muted. In fact, the Employment Cost Index report that was just released had the wage and salary component at a record low for that measure. The result is that wages now account for the smallest share of what is considered "total personal income" in history, at 55%.

**Q:** *Go on.*

**A:** The other force I see for stagflation is rooted in monetarist theory. Namely, the fact that the Fed is tightening. By draining liquidity from the pool, the Fed is refusing to accommodate broader inflation pressures. Essentially, it has created an environment in which as one price goes up, something else must go down. Either that or people have to buy less at the higher price . . . e.g., more inflation and fewer units . . . a pretty apt description of stagflation.

You're seeing this dynamic play out at the low end. Here, consumers have actually been forced to make budgetary decisions . . . a foreign concept over the past few years! Just look at the response to WalMart's attempt to be less promotional over the holidays. In my view, as this "stagflation" dynamic intensifies against a backdrop of constrained consumer purchasing power, the shift away from consumer-discretionary stocks to consumer staples should gain momentum.

With regard to interest rates, this environment of receding liquidity I described—wherein nominal growth is fixed and you simply shift up the mix between inflation and real growth—seems likely to be mirrored in bonds, with nominal yields generally trending sideways while beneath the surface, the inflation premium is rising and the real yield falling. Of course, there is one important caveat.

**Q:** *What's that?*

**A:** The Fed controls money, but more than ever, the markets control credit. So, the fact that the Fed is tightening doesn't ensure that liquidity or credit is tight. Indeed, as we saw last year, the markets can completely flout the Fed. Even as the

Fed raised rates, the credit markets continued to ease, with yields on Treasuries and all manner of corporate bonds declining in unprecedented fashion.

**Q:** *So much for "Don't fight the Fed."*

**A:** Yes. That said, there are now clear indications that the growth in credit is slowing. The most impressive evidence of this is the consumer, where, despite continued low mortgage rates, refinancings—and particularly cash-out refi—has declined.

More importantly, home-equity loans, where much of the marginal growth in credit has taken place, have slowed dramatically in recent months. The annualized growth slowed from a record high of \$150 billion to \$70 billion.

All of this is so critical because credit has been filling the ever-widening void I alluded to earlier between spendable income, namely wages, and consumption, as more of income takes the form of benefits. Against this backdrop, as the availability of cheap credit, or the willingness to use it, begin to wane, consumption seems sure to slow—materially—and the economy's stagflationary tendencies take center stage.

**Q:** *You've been extremely bearish on the U.S. consumer for more than a year. But the upper crust has been nothing but resilient.*

**A:** Absolutely. But I think what would be fascinating is if there was an analysis in which someone could strip out how much of the real strength at the high end is sort of masking what could possibly be a recession at the low end. We don't see it because, in the aggregate, the overall retail numbers look okay. Bottom line is that I'm not particularly concerned about the high end.

**Q:** *Why?*

**A:** This segment may actually do okay because they will be on the receiving end of the transfer of income from the corporate sector, as they have stepped up their activity in share buybacks and dividend payouts. However, corporations are hitting a very narrow segment of the consumer sector, and it happens to be the high end.

I think the Fed and the Bush Administration would much prefer com-

panies to actually go out and hire people, which would be a wealth transfer to, perhaps, the middle class that really needs it.

**Q:** *Let's get this straight: The labor market isn't falling apart.*

**A:** I look at this chart of undistributed corporate profits, which got as high as about I think \$500 billion, and now it's around \$440 billion, because corporations have been paying out dividends, etc.

And I look at the chart and it literally keeps me up at night because I think to myself, you know, some day some big-time CEO is going to come out and announce that we've turned the corner, it's time to increase capital expenditures and every other chief executive officer in

his industry is going to line up to do the same thing. It will be like flipping a switch and all of a sudden we will have a meaningful upturn in investment and that will be attended by employment.

But the shocking thing, obviously, is that they have been sitting on this cash and they are not doing anything with it despite incredible incentives to spend it, not just fiscally but from an interest-rate standpoint. It's not like keeping and sitting on cash is a particularly compelling investment idea right now. It speaks a lot about the environment that CEOs see out there with potentially the continued overhang that we've got from the post-bubble period.

I don't want to be overly apocalyptic, but to think that three years after the greatest-ever investment boom of our lifetime, CEOs would run out and want to expand and spend might be a little bit optimistic.

I guess my point was going to be that I see a period where we have sort of sub-par employment growth because we are still working through these excesses.

**Q:** *What is sub-par to you?*

**A:** Let's say [nonfarm payroll increases of] between 100,000 and 125,000 a month.

**Q:** *I know you don't change your forecast very much. But what will?*

**A:** You know, what I think would sway me more from my forecast would be if I heard [about] companies using money, either the money that they are repatriating or the cash that they already have on

## Pomboy's Picks

Security	Recent Yield	
10-Year Treasury note	4.18%	
Gold	\$420*	
Company	Ticker	Recent Price
Newmont Mining	NEM	\$40.88
Placer Dome	PDG	17.06
Gold Fields (ADR)	GFI	11.11

\*Recent price per ounce.



hand, to increase cap expenditures and employment.

And I still don't hear that. Maybe I have a tin ear. But you know, if anything, the recent surge in merger-and-acquisition activities strikes me as sort of the long overdue consolidation needed after this massive investment bubble, and it will probably lead to increased layoffs—not increased hiring.

**Q:** Which all comes back to your concerns about the consumer?

**A:** Already, consumer purchasing power is limited by this lackluster income growth, specifically wages. People will argue, "Hey, income growth is actually pretty good now." But it's primarily benefits and people can't spend their benefits. And that I think is why you've seen in part this huge increase in consumer debt. It's not just because it's cheap and you know it's there, but increasingly, people need it because their wages aren't covering their basic consumption.

**Q:** Do you have some numbers?

**A:** Yes. Well one thing I look at is the diminishing marginal returns on credit, in that it takes more and more debt now to fuel each marginal dollar of consumption. It now takes 11 cents of new debt to generate each additional dollar of consumption. That's up from just three cents in 1992. And it's the highest ratio of debt to consumption since 1985. Of course, there are also all the standard metrics of how levered the economy has become... like the household debt-service ratio which is just off record highs at a time when interest rates are bouncing along 40-year lows.

**Q:** That's why interest rates will remain stable?

**A:** It strikes me that the yield curve might be sending you the signal that basically this is an economy that just can't handle significantly higher long rates. We've gotten to this point on the back of consumers' borrowing, and they are extremely extended and while employment is picking up, it's still not sufficient. I always picture that scene from *A Few Good Men* where Jack Nicholson says: "You can't handle the truth!" And I'm thinking we just can't handle higher rates. I mean that's it.

**Q:** The economy has a very low threshold of pain for higher rates?

**A:** I think it takes less and less of an increase in rates to snuff out economic activity, and it seems like a statement of

the obvious. I mean, we've got more and more levered, of course, and it would take less and less of an increase in rates to slow this whole consumption engine down. Consumer credit or cheap credit is the stuff that keeps this economy moving. Raise the price of that, and we're going to move a lot slower. I think that is in part what the yield curve is saying is that this is an economy that's built on a continued supply of cheap credit, and if we want to keep moving forward, we can't let long rates move significantly higher.

**Q:** Sounds like you are still bullish on bonds, particularly the long end?

**A:** As long as the Fed stays its measured course and the markets take the liquidity tide out, bonds should continue to frustrate the bears. My bond call is strictly a trading—not an investment—call. I am bullish on the long end. Although, to be honest, I don't find the 30-year as compelling as the 10-year. While the supply story is better for the 30-year—in that there's less supply—the 30-year has massively outperformed the 10-year. Thirty-year yields recently took out their spring '04 lows, and are now gunning for their summer '03 [Fed. governor Ben] Bernanke-deflation-scare lows.

Meanwhile, the 10-year is still well above its spring '04 lows. Also, the spec position—and resulting potential for short-covering—is higher in the 10-year note. In fact, it's double that of the 30-year. So, I'd rather bet that the 10-year plays catch-up and tests its spring '04 lows, which would represent about a 45 [hundredths of a percentage point] decline in yields from here.

**Q:** Let's talk about the dollar. In your July 2002 report, "Race to the Bottom," you made an early—and right—call on competitive devaluations. What now?

**A:** As we entered 2005, it struck me that everyone was in agreement that the dollar was going to continue to go lower at least at the end of last year, as they made their forecast for 2005. And the markets were sort of cheering that as a guarantee that the great deflation [where government attempts to tweak output using various stimulus tactics] and the abundant global-liquidity party would continue, because a weaker dollar ensures that the rest of the world is going to have to debase their own currencies if they want to continue to trade with the U.S.

So the easy money will continue to flow. At the risk of saying it's different this time, I think that we've reached a point where the willingness to want only

to debase one's currency around the globe has started to decline, particularly in Japan.

Which has led me to conclude that in 2005, the dollar which has heretofore acted as a uniter—bringing global economies together in the common purpose of debasing their currencies so as to maintain their export audience with the U.S. consumer—will now become a divider.

As one country after another concludes the destructive consequences aren't worth the reward, it's no longer guaranteed that when we have a weaker dollar, the rest of the world is going to rush to try and weaken their currencies in response; therefore the global-liquidity floodgates will be thrown open, and money will flow like mad. We've now pushed the rest of the world to the point where they've had enough.

So my sense is that, contrary to the conventional wisdom that this sort of global liquidity will continue to flow and a weaker dollar will ensure that this high-beta game keeps going, we will experience the opposite. I think the deflation trade is over, and it's going to be much harder to make money in the year ahead.

**Q:** But you have been a huge fan of gold. Why own it now if you think the deflation trade is over?

**A:** Most people view the two as inextricably linked. However, I'm not most people.

I think the deflation trade is over insofar as the rest of the world is no longer going to follow us down the path of the currency debasement. So the global-liquidity spigots will begin to close. However, here in the U.S., we clearly have an agenda to weaken the dollar. Therefore, as someone who resides in the U.S. and earns a living in dollars, I think having gold is a vital hedge against what we are clearly trying to do politically... namely, inflate away our debt.

**Q:** And are there any fundamental reasons to expect the dollar to continue to go lower?

**A:** Circling back to my earlier comments on the economy, I believe that we will reach a point where the Fed actually ends up having to reverse course—as evidence mounts to suggest that this levered economy simply "can't handle the truth" when it comes to higher rates.

As foreign central banks make fewer appearances at our Treasury auctions, and rates begin to rise, the Fed might soon find itself forced to assume the role

of buyer of last resort. Then there's the very real possibility that the retreat of global liquidity precipitates a financial crisis. This, as ever, would surely find the Fed rushing in to mitigate the pain. Any or all of these would further undermine the dollar's already-limited virtues and enhance the appeal of gold. If you believe, as I do, that the dollar is headed lower, \$500 gold is really a no-brainer.

**Q:** *How about gold stocks?*

**A:** I am long gold stocks. I have positions in the usual suspects, like **Newmont Mining** and **Placer Dome**, and so on. But, right now I am most excited about the South African gold stocks.

**Q:** *But the mining companies are suffering because the rand has been so strong.*

**A:** Exactly. That has been the problem. The rand has been relentless! In part, this has been because the central bank has refused to cut rates as dramatically as the economic fundamentals would seem to mandate. Short rates in South Africa are 7.5%, yet inflation is under 4%. This hasn't escaped the carry-trade speculators, who have exploited this unique opportunity to get 7.5% without stretching out on the maturity spectrum while getting a strong currency to boot. This, of course, has only intensified the upward pressure on in the currency.

But the rand is now, finally, beginning to reverse as it becomes clear that the central bank will be more aggressive and specs begin to pack up and head home. This should help alleviate the intense profit squeeze that the strength in the rand has had on South African mining companies.

**Q:** *With all this talk about gold, I have to ask: How has your father, a former gold bug on Wall Street, influenced your take on the yellow metal?*

**A:** The influence my father has had on me is much more general. When I was growing up, I remember very vividly getting in the car with my mom and driving to the train station every day to pick up my dad coming back from New York after work. And every day he'd get in the car and she'd ask, How was the market today? And he'd say it was great. And I had this picture of my father hosing down the vegetables in the produce section of the market. I thought by the market she meant the grocery store.

**Q:** *That's hysterical.*

**A:** But you're right, from a young age I was interested in learning about what went on at the market. And now I know.

**Q:** *Thanks, Stephanie. ■*