

INTERVIEW | SATURDAY, FEBRUARY 26, 2011

Why the Maven Is Morose

By LAWRENCE C. STRAUSS

MacroMavens' Stephanie Pomboy doesn't believe the recovery is good for the long haul, and she's recommending Treasuries and gold.

When *Barron's* interviewed Stephanie Pomboy **at the end of 2008**, she was pretty gloomy about the U.S. economy. That hasn't changed. Contrary to the bullish camp, which expects a strong economic rebound, Pomboy sees no evidence to support a durable recovery. Pomboy is president of MacroMavens, a Manhattan firm she founded in 2002 that specializes in analyzing macroeconomic themes and their investment implications. Her favorite plays include Treasuries -- which, she maintains, will rally once more economic data reveal a tepid recovery at best -- and gold. The 42-year-old analyst views hard assets as a hedge against what she expects will be the dollar's continuing weakness.

Barron's: *Let's start with your macro view of the economy.*

Pomboy: Not surprisingly, given my skeptical nature, I am dubious about the strength and durability of the recovery. The markets are clearly perceiving that the recovery has moved from, let's say, tentative to solidly durable, and that's been manifesting in various markets since the beginning of the year. But I'm skeptical for a variety of reasons. The stimulus is going away. You have this seasonal-adjustment hurdle that really moves from very low in January to very high in March and April.

Could you elaborate?



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The government basically assumes that, every March, retail sales go up, let's say, 12% from the month before. So it makes for a very high threshold. If you get retail sales up only 10%, that number hits the tape as minus 2%. Another challenge is the year-on-year comparisons, which will be tougher as the year progresses. So all of those things conspire to present weaker data in the months to come, to say nothing of how we've now got these twin drags again of higher interest rates and higher commodity prices. So you have fundamental drags on the consumer at a time when employment and wage growth aren't really there to provide offsets.

When you mention higher rates, you're referring to the 10-year Treasury, which now yields around 3.60%, up more than one percentage point since last fall, right?

Yes, and it's also starting to impact the mortgage market. If you look at the combination of higher rates and energy prices, we are really now running at levels that we haven't seen since just going into the financial meltdown. To quantify it, over the past six months, wage income is up \$111 billion, and outlays on food and energy are up \$116 billion. So the little job growth we have managed to create has been muted by the increase in just food and energy outlays, to say nothing of what happens when this reset parade happens for ARMs [adjustable-rate mortgages]. Starting in April, there will be another wave of ARM resets. We had this last year, but it was muted because rates weren't an issue; lower home prices were a drag. Today, both factors are relevant, as home prices have re-accelerated to the downside. At the same time, mortgage rates are starting to notch up. So the reset wave this year could be much more punitive to the economy generally and consumers specifically than it was last year.

Where does the economy go now? A double dip?

Clearly, growth will slow. It's a question of how sharply, and the answer to that will depend a lot on whether the corporate sector is, in fact, starting to improve. Already we've seen a slew of stronger industrial readings, although there, again, I can find a lot of reasons to be suspicious. You have had both the ISM [Institute for Supply Management] and the Philly Federal Reserve indexes being very strong, but they are diffusion indexes. They tell you a lot about direction, but less about degree. After the dramatic declines that we saw after the recent financial crisis, the fact that directionally we're moving up from those lows is great. But it isn't necessarily as strong as these headline numbers are being interpreted.

So, you don't buy the argument that the U.S. economy is on its way to a strong recovery, high unemployment notwithstanding?

I don't. I don't see the ingredients for a durable recovery. To say that the economy looks fine, excluding the fact that we are not creating any jobs, strikes me as a pretty major "except." We need to create real income. Let's say we go back to our old ways, which [Federal Reserve Chairman] Ben Bernanke is trying frantically to get us to do -- that is, if consumers aren't going to have wage gains, they could instead borrow the money to spend. And yet consumers seem to be evincing a new attitude about debt. The people who really desperately want to borrow aren't being offered the opportunity. And the people who are really better-quality credits don't really have the appetite to borrow anymore. So, absent some kind of dramatic change in the consumer's willingness to borrow or a dramatic increase in job creation, I just don't see the ingredients for a durable recovery. And that's why I come back to this notion that the stimulus is now coming off, and we are going to have that moment of truth as to what is the fundamental growth rate of the economy, excluding all of these temporary supports.

Let's move on to your recent research note, which is titled "Springing Leaks." What are some of your key points?

I think the Fed isn't anywhere close to tightening. But the markets have pulled forward expectations of tightening from the November Fed meeting to the September meeting, on the back of these stronger data points. But it is almost laughable to think that the Fed can tighten in this environment. I expect that, at the end of June, unless you have had one of the two things I mentioned -- a spontaneous increase in consumer borrowing or an increase in job creation -- the Fed will be forced to extend QE [quantitative easing], because it needs to arrest this back-up in mortgage rates before it starts to get into those ARM resets. And it also needs to mitigate the blow from higher commodity prices.

Where do commodities fit into your view of the economy?

It is delicious in its irony, in a way, that QE is really the driver of this commodity bubble, because, obviously, when the Fed started putting rates to artificially low levels, everyone in the U.S. looked somewhere for higher yields. And the obvious place to go was emerging markets, and all the capital flowing into emerging markets fueled their economies and increased their demand for resources. At the same time, debasing the dollar obviously enhanced the allure of holding hard assets, which also benefitted commodities. You can find any number of reasons why QE really drove this commodity boom. So if I'm correct that the Fed is going to have to continue this program to protect the U.S. recovery from these threats of higher rates, and food and energy prices, it is kind of ironic that they are going to be pursuing more aggressive quantitative easing, even though that is really what is driving higher rates and commodities.

Not only do higher commodity prices feed inflation expectations, bidding up interest rates, but you also have the direct impact of higher commodity prices siphoning liquidity from the Treasury market, as our foreign, one-time creditors say, "Oh, no, now I have to pay an extra dollar on oil." And you see that in recent international flows.

It is not for nothing that the emerging economies, which really are the biggest consumers of commodities, are the ones that were sellers of Treasuries. They really need to use these dollars, and urgently, because they don't want to have an Egypt-style situation on their own hands. So you see articles every day about how countries from Brazil to China are starting to stockpile resources, and they are using forex [foreign-exchange] reserves to do that. So it isn't just some kind of abstract theory; it is actually playing out. Take China, for example. Over the past three months, China has been a net seller of Treasuries.

What does all of this lead to?

If we pursue this logic to its natural conclusion, and the Fed continues with QE, it begets more of the same result, which is just to continue to inflate commodities. Then what happens is that we see commodity prices rise until they reach the point that something breaks. And my thesis is that, during my lifetime, interest rates have always been the catalyst for a crisis. Rates backed up to the point that some weak link in the chain broke. This time, however, higher commodity prices will be the catalyst. But, again, it is deliciously ironic that these higher commodity prices are a function of overaggressive, easy monetary policy. In times past, it has always been tight monetary policy that precipitated the crisis.

What about the argument that Bernanke and his team had to do something or the economy was going to fall off a cliff, and that they had to create liquidity?

It is easy to sit back and say this. But had the Fed not had that attitude back in 2000, we wouldn't have been in this predicament. The problem is that we serially try to reflate our way out of these problems, rather than taking the pain and letting the economy actually cleanse itself. So I have the luxury of saying I wish they had done nothing. But, of course, they all would be out of office if they had done that.

Nevertheless, I see continued QE inflating this commodity bubble to the point that something breaks. The question is, what's that something? But in the meantime, while we tap our fingers and wait, clearly there is going to be a lot of trading opportunities around the idea that commodity prices will continue to go up. And that emerging economies have a cushion against that in the form of these vast forex stockpiles, which conveniently are largely denominated in dollars -- which is what commodities are priced in.

At the end of day, the emerging economies have an ability to absorb some of the commodity-price increases that the developed economies, like the U.S., Europe and Japan, don't. When you look at the market since the beginning of the year, the perception is that the U.S. economy is really moving into durable-recovery phase, and you had a rotation away from emerging markets to developed economies. If you look at the emerging

markets vis-à-vis the S&P [Standard & Poor's 500], the S&P has really outperformed. One of my favorite trades would be to rotate back the other way. People are going to discover the view about the durability of the U.S. economy is overblown, and they will rotate back toward emerging markets.

What other trades make sense?

Clearly, at a time when consumers don't have wage income and they seem reluctant to borrow, there isn't a lot of room for them to pay higher prices. So I view the commodity-price inflation as really a major margin squeeze for the corporate sector, more so than anything else. That's another theme I would play by selling or being underweight small-cap stocks, which have been just on fire. I would definitely overweight large-caps vis-à-vis the small-caps, which are really going to be most vulnerable to these kinds of pricing pressures.

At the top of my list, I would be long hard assets, including gold and Treasuries, on the expectation that people will be disappointed by the economic data coming up, in part because of the seasonal and statistical issues that I mentioned previously.

If you look at the speculators, they had a huge long position in Treasuries at the end of last year, but they've flipped them into a really sizable short position in just a couple of months.

Are there any other themes that come to mind?

Another is related to consumer discretionary spending, which, again, is an area where disappointment would be particularly punitive. I would be looking to short some of the discretionary stocks, including **XRT** [SPDR S&P Retail], an ETF that gives investors exposure to retailing. And with this mortgage reset wave unfolding against a backdrop of higher food and energy prices and consumers who don't have the government support from transfers and stimulus anymore, I would be looking to short the financials again. I think we are going to have some mortgage mayhem.

When we spoke with you at the end of 2008, you predicted a prolonged period of subpar growth. Is that still your view?

Yes. That was based in part on my expectation that the period after the housing-bubble bust wasn't a standard economic cycle. Instead, I thought it was going to lead to a secular shift in consumer behavior and that consumers would be chastened from borrowing aggressively and they would try to live more within their means. And that would translate into a sustained period of subpar growth. And I continue to believe that to be true, and the two years of intervening data support this idea that there is some kind of shift. We don't know what the magnitude of it will end up being. But, clearly, the appetite for credit is not what it was before the housing bubble went bust.

This is all pretty gloomy. Any potential silver linings?

The best-case scenario -- and what Ben Bernanke is working really hard on and what hopefully will happen -- is that by inflating assets, even nominally, and getting the equity market to recover a lot of the ground that it has lost, high-end consumers will feel emboldened to go back out and spend. And since they really drive marginal consumption in the economy, eventually their spending will motivate companies to go out and hire and really feel better about expanding or believe in the durability of the recovery. So that's the hope. And every time you get some glimmers of life at the high end, it is very exciting. And then, all of sudden, it looks like it dissipates. So we'll have to see. For me, the next couple of months will be critical, as we see the stimulus come off and we get into the challenging year-on-year comps and we get a real sense of the economy's ability to stand on its own two feet.