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By John Mauldin

In what is the shortest e-letter I have written in years, for which many of you will be grateful, this week we once again delve into Fed policy. Should they raise rates in June? The even tougher question is “Will they?” Plus we look at a very disturbing report that Chinese firms are unable to secure letters of credit for sizeable amounts of soybeans that are already in port. What is going on? Is it a bureaucratic snafu or a sign of real problems?

But first, I must acknowledge my real (and embarrassing) proof-reading difficulty last week. I meant to write: “… not my normal gentil self…” trying to be cute and show my limited French vocabulary, rather than the correct English word of genteel. Somehow, (spell-check?) it came out gentile in the copy. I was not meaning to imply anything about the various dispositions of any ethnicities and hope I did not offend anyone.

It’s Time for the Fed to Reload

I have argued for almost two years that the Fed would not raise rates prior to the November election, for a variety of reasons. In summary, they were worried about deflation, did not want to appear to meddle in the election cycle, were worried about the true underlying strength of the recovery, and actually would welcome a little inflation.

Today, I am going to change that stance somewhat. The facts have changed, and in the face of that, I need to change as well. I am not sure whether or not the Fed will raise rates in June, but I am going to argue that they should.

There are two basic scenarios in our economic future: either the economy will continue to improve or it will soften. In either case, I think it is the right time to begin to raise rates. Let’s start with the first scenario, as it is the easiest to explain.

Many observers have argued that if it were not a political year, the Fed would already be raising rates. I disagree, as I think they have held off as long as they have out of fear of deflation. The fear, which was so powerful less than year ago, has abated, and now we hear talk from various Fed types about inflation.

If the economy is indeed growing and the recent trends in employment are solid, the Fed can slowly begin to raise rates without threatening that growth. In fact, to not do so invites all sorts of problems. Leaving rates too low for too long can bring back inflation that would be uncomfortably high. It creates the potential for (more) asset

bubbles fomented by the "carry trade" (borrowing cheap money short term and lending long term).

A 25 basis point rise in June and again in August, skipping September and then resuming the gradual rise, accompanied by a clearly worded policy, would allow markets to re-balance. In a growing economy, such a gradual rise should pose no problems. Yes, it might even allow for inflation to rise above 3% (or more), but I do not think the Fed would be altogether too concerned about such an eventuality, seeing that as the price of a stable recovery. For reasons I will outline below, they might even see 3% as something desirable.

The economy is indeed growing and looks to be poised to do so for at least the next six months, if not much longer. That is a good thing. The bond market is pricing in a rate hike. Even if the fed were to raise rates 25 basis points (one quarter of one percent) in both June and April, a 1.5% rate is still VERY low and will provide lots of extra stimulus through the election. Eventually, they could get to 2.5% to 3% by the end of next year, or where many feel the rates should be. If inflation rises to 3%, they could raise rates to 4%. Remember, it was only a few years ago that rates were over 6% and the economy was growing.

What If the Economy is Slowing?

There are those who argue that the economic recovery is more fragile than it seems, dependent upon ever growing consumer spending and new home construction. I admit to being in that camp. The economy is so dependent upon low rates and stimulus that anything which threatens to raise mortgage rates and interest rate costs for consumers will potentially stall the recovery. In a few paragraphs, we will go over the numbers, and it does indeed look problematic.

But that would, in a counter-intuitive form of logic, be all the more reason to start raising rates in June. Let's work through the thought process.

First, all recessions are by definition deflationary in nature. By that, we mean that inflation drops during recessions. If inflation is already low, it can mean a drop into outright deflation. Typically, what central banks do in such a circumstance is to add stimulus to the economy by lowering rates, adding cash reserves at banks, increasing the money supply, and so on, to bring about a return of growth and inflation. The Fed, throughout the 80's and 90's, opportunistically fought inflation by using recessions and other slower growth periods to wring out the inflation of the 70's. They did so successfully.

But what if we had a recession in today's interest rate environment? How can you lower rates beyond 1% and have any meaningful effect? The answer is you could not. You would have to provide other forms of stimulus, or risk deflation. You could "move out the yield curve," lowering rates at the one or two year level (or longer term, whatever it takes) to bring back growth and inflation. We have discussed this aspect of Fed policy

before. Suffice it to say, the Fed is committed to doing whatever it takes to avoid deflation.

There will be a recession in our future. The business cycle cannot be repealed. It is not a question of "if," it is simply a matter of when. Think of each 25 basis point rate cut as a bullet. If the Fed does not reload its inflation fighting gun with bullets, it will be forced to use its unconventional arsenal. There is little or no experience in the modern world with such weapons. They may work just fine, in a long term relative sense. Were such a need to arise, it would be in a very difficult recessionary period in which only an economist could use the words "just fine." The alternative arsenal may also be Weapons of Mass Capital Destruction.

Frankly, none of us want to know if the unconventional arsenal will work without creating even more problems. It would be much better if the Fed could use its more conventional tools. But right now, the interest rate gun is empty.

Raising rates in June and August would start the process of reloading the gun. The Fed is going to need those bullets someday. If 50 basis points did any real economic damage in an economy growing more than 4%, then there are much larger problems at work. A half-percent rate increase will not be the culprit. Waiting until November would mean much faster rate increases next year, say 50 basis points a meeting, as opposed to a steady-as-she-goes policy, which might be more problematic.

A Problematic List

Let's look at the reasons to be concerned. First, fixed mortgage rates have risen in nine out of the last ten weeks. They are now at 6.32%, a full one percent higher from 12 months ago, and almost a half-percent higher in the last month. This is clearly slowing home sales, which were down 11.8% in April, the largest single month decline in 10 years. The rise over the last month will almost surely lower sales again in May.

But new home inventories are up and new housing starts are up dramatically, as inventory builds because of lower sales. New home sales are still good when looking back over history, but the trend since rates began their recent rise is not good.

A sound argument could be made that the mortgage market has already built in a "Fed rate rise" factor. But even a 50 point rise in short terms rates will move mortgage rates a little higher. There is an increased use of adjustable rate mortgages, which will in fact go up as the Fed raises rates. Re-financing, a significant source of stimulus over the past year, is in decline.

(Next week, we take an in-depth look at the housing market. Is there a bubble? I will leave you with one interesting thought in the meantime. How much of the rise in home prices can be laid at the feet of the fact that the average size of a home has doubled?)

Rising interest rates will hurt housing, debt laden consumers and businesses that use debt. If wages, employment and income were rising at the same time, then rising rates would not be a large drag. But there is little rise in real income and wages. High oil prices also act as a tax on the consumer.

The Chinese government is clearly trying to slow their red-hot economy down. Stephen Roach at Morgan Stanley seems convinced that they will overdo it. A slowing China will not be good for the US economy.

All of this makes for the potential of a slowing economy over the next 12-24 months. Waiting until the economy is visibly slowing means that rates will not be raised without serious consequences. And that means the use of unconventional weapons to fight deflation. Mr. Greenspan, raise rates now.

The End Game

Bill Gross, the Bond King from Pimco, argues in his monthly letter that the world economy is a circus act, walking on a tightrope, with inflation on one side and deflation on the other. It is an apt analogy. An excellent essay, you can read it at www.pimco.com.

Morgan Stanley analysts suggest that 98% of the increase in world GDP for the last ten years is due to the United States, which means the US consumer. This is simply not sustainable. The real circus trick will be to rebalance the world growth equation from a very US centric one to a more balanced model without causing a major, simultaneous world-wide recession. This will be difficult given the demographic pressures in Europe and the US. To do so will mean that all of Asia, not just China and India, must develop their own consumer economies. Given the historic propensities of Asian cultures to save large amounts of their income that will be more difficult than it seems. In that regard, the recent rise in the Japanese economy and consumer spending is a very welcome sign. Latin America also needs to redefine itself.

That re-balancing, which almost certainly has to start happening this decade, is the end game. It will be the final act in the current long term American economic cycle begun at the beginning of the last century. It will affect everything. Stocks, commodities, currencies, real estate, interest rates and inflation worldwide, all will be subject to the influence of the process. Some of it will be for the very long-term good and other aspects will not be comfortable. I have been thinking a lot about this lately, and will be writing about it a lot over the coming year.

Who’s Picking up the Soybean Tab?

The following story I have only seen in Dennis Gartman’s daily letter. I print these paragraphs and offer some comment afterward.

“Regarding grain, the focus is on China where rumors are rampant concerning the possibility that 20-30 full cargoes of soyabeans shipped there are in jeopardy of being

defaulted upon as the buyers have not secured letters of credit. As our friends, Bob Lekberg and Tom Pfendler of Goldenberg, Hehmeyer wrote late yesterday regarding this impasse our commercial sources suggest the shippers themselves do not even know what the outcome will be. They do not know if they are long or short. Frozen by the situation, trade presently with China is not feasible. Plus, many of the major shippers are on the black list already and could not sell to China even if they wanted to.

"This is the absolute worst news that could come out of China; trade in grain there is at a standstill, and we are left to wonder what it shall mean for trade in any and all other 'commodities....' or manufactured goods... or even services for that matter. The inability to secure letters of credit may be 'one-off' to the grain market; but what if it is not? What if this is a problem of much greater potential? This is indeed worrisome; this is very, very worrisome, and its broader implications may be far more serious than we might willingly wish to imagine."

In a follow-up discussion with Dennis, there are mostly questions left unanswered. It is doubtful this is a government act, as it would be a foolish one. Are several small businesses trying to manipulate the markets or squeeze suppliers? Possible, but again, it would be a one-time act, for no shipment would ever leave port bound for China again without fixed letters of credits already in place. Since they need the soybeans, what is the motive? Is there a breakdown in the banking/credit system? Is this a one-off problem, or is it the first of a cascade of private financing problems.

We can only hope this is some bureaucratic mess and will get shortly and quietly fixed. A serious problem with Chinese credit would be a disaster for the world economy.

And speaking of China and problems, there is an absolutely fascinating discussion among Morgan Stanley economists about the current rise in oil prices at http://www.morganstanley.com/GEFdata/digests/latest-digest.html. For those reading this later in the week, it is in the Morgan Stanley archives for May 28. Buried in the discussion were these facts about China and oil from analyst Andy Xie.

"Surging oil demand for oil from China is the primary cause for the high oil price. Chinese demand is currently increasing three times as fast as the trend in 1990s. Global demand was rising by about one million barrels per day every year in the 1990s. Chinese demand is now rising at that speed by itself…

"China will have to change its energy policy. If left to its own devices, an extrapolation of recent trends suggests that China's oil consumption could double over the next decade, from 7 million barrels per day in 2004 to 14 million barrels per day by 2014. The problem with this forecast is that China can't afford the resulting cost of higher oil. Considering the limited spare capacity in Saudi Arabia, the China factor, alone, could drive up the oil price above $80 over the next ten years. At that price, China would have to spend $300 billion to import crude and related products per annum by then. It would be a huge drag on the Chinese economy, to say nothing of its impact on the rest of the oil-consuming world…

"The choices are relatively simple: China has to become either much more energy-efficient or find a substitute for oil. But it takes 10 years to build a nuclear power industry. China has to act soon if it wants to adopt the nuclear option. Another alternative is to limit the growth of the automobile industry. The current growth trend could result in a tripling of China's fleet size to 100 million by 2014. Unless China alters this growth path, it will be too late to slow oil demand."

Ayn Rand and a Fountain of Objectivity?

A reader writes at Amazon.com: "[Bull's Eye Investing] may be only 400 odd pages, but it is so packed with relevant information and cogent thought that you'll need to read it three times to absorb it all. Therefore, I feel safe calling it the new Atlas Shrugged, which if you have read you know is over one thousand pages of compelling capitalist perspective on how American ingenuity is used and abused by the trappings of socialism. John Mauldin (a.k.a. John Galt) exposes the profiteering nature of the emperors of investment punditry and investor manipulation, as Ayn Rand struck against the suicidal human nature of taking from those who have the greatest ability (investors) and giving to those who have the greatest need (financial managers). Enter Bull's Eye Investing, where we find those who have entrusted their hard earned savings poised for pilfering by brokers and advisors who can't see beyond their own commissions to the reality of market and economic cycles. Read this book and recall how many brokers have told you 'Hey, I have to make a living too,' as they insinuate themselves into your asset management. Praise Mauldin for risking personal excoriation at the greedy hands of his industry for drilling into our heads that when money is involved, truth is the first victim."

I only blush a little, but appreciate the sentiment. You can get your own copy, packed with relevant information and cogent thought, at your local bookstore or www.amazon.com/bullseye.

The Dutch, CNBC and New York

As I close and get ready for a long weekend, which sadly will find me working for most of it, I must apologize for my (I thought humorous) remarks about Amsterdam and drugs, which brought a flurry of replies from the Dutch, chiding me for my lack of knowledge. So for the record, I love Amsterdam and its charms and museums and history. I love the Dutch who are some of the most educated people anywhere (have you ever met someone from the Netherlands who is not fluent in at least three languages?).

I will be in New York June 7-9. On the 9th I will be on CNBC with Ron Insana, presumably in the first part of his show. The PR people for the book say there may be more TV and radio as well. My schedule is still firming up, but I may host a happy hour for clients and new friends one afternoon, depending upon the schedule.

My bride is in Puerto Vallarta for some personal R&R. My writing schedule is way behind, so I remain chained to the office. But I will take some time to spend the

Memorial Day weekend with family and friends and reflect on the freedoms that have been bought so dearly. I trust you will enjoy your holiday.

Your pondering the effects of the end game analyst,

John Mauldin