Donald Luskin, Chief Investment Officer
David Gitlitz, Chief Economist
Thomas Demas, Managing Director

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Grasping At Straws

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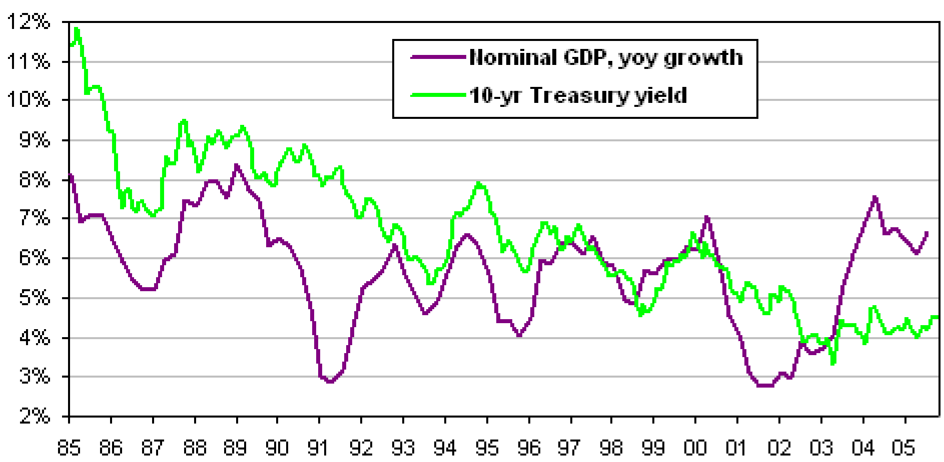
David Gitlitz

The rationales coming from the inflation doves don't hold up.

In the past week the popular notion that **the Fed** is close to -- if it hasn't already arrived at -- the stopping point in its **rate hiking cycle** has been dampened to some extent, with the nearly 10 basis point move higher in the **10-year Treasury yield** closely tracking out-month expectations for further Fed action. At an **implied yield** a touch above 4.7%, July **fed funds futures** are nearly fully priced for the funds rate moving another 50 basis higher by the late June **FOMC** meeting. A week ago, the July contract was fully priced for one more 25 bp move, but showed just a two-thirds chance for a second hike.

In fact, we see these expectations, while moving in a more realistic direction, still at least 25 bp below the minimum 5% funds rate likely to prevail at mid-year barring a substantial **economic slowdown** in the interim, an outcome which we assign a low probability. Our confidence in this scenario is bolstered by the fact that the arguments being offered to support the proposition that the Fed should get out of the rate hiking business forthwith fail to withstand scrutiny.

Yesterday's ***Wall Street Journal***, for example, carried a story featuring the view of widely followed **Wall Street economist Ed Hyman**, who maintains that **long-term yields** are a symptom of **low available returns** which, given the **flat yield curve**, suggest that higher **short rates** would risk serious economic harm. "These low expected returns have ramifications on economic prospects," as the story represents Hyman's view. . "It gives companies less reason to spend money on equipment or new hires to expand. It gives venture capitalists less reason to find budding businesses. In short, it discourages investment, and makes economic growth harder to come by as a result." Finally, the story concluded, "Today's low short-term rates may be plenty high."



A good proxy for economy-wide available returns is **growth of nominal GDP**. In a report yesterday, we produced a chart showing that the gap between nominal GDP growth and the fed funds rate remains nearly unprecedented (see ["Accidentally on Purpose"]() January 11, 2006). In the chart above, we show the benchmark 10-year Treasury

http://www.trendmacro.com
don@trendmacro.com
dgitlitz@trendmacro.com
tdemas@trendmacro.com

Offices:
Menlo Park CA
Parsippany NJ
Charlotte NC

Phone:
650 429 2112
973 335 5079
704 544 6900

yield against GDP growth over the past 20 years. The fit between the two, as seen in the chart, has been quite close over the years. A break occurred following the second quarter of 2003. That's when nominal GDP, due in part to the **ultra-easy** stance of **monetary policy**, began accelerating. Normally yields would have started rising around the same time as the market figured Fed rate hikes would not be long in coming. Instead, the Fed began offering repeated assurances that rates would remain highly accommodative for a **"considerable period,"** essentially holding short rates below their market clearing level, setting in motion the **inflationary dynamic** that we have detailed on numerous occasions.

A year later, the Fed began raising rates at a **"measured"** pace, reassuring the market that a return to **policy normality** would be carried out in a predictable and methodical fashion. Even after 325 basis points in rate hikes, the **inflation-adjusted funds rate** at just over 2% remains quite low by historic standards (using the **PCE core deflator**, which is the Fed's preferred inflation index, the real rate has averaged nearly 3% over the past 25 years). Anchoring the **term structure** to such a low real rate, together with the Fed's ever-ready mantra that core inflation remains **"contained,"** have been the primary factors keeping long-term yields in check.

Certainly, there is a dearth of evidence to support the view that **investment** is being discouraged by the low available returns supposedly reflected in long-term yields. **Capital investment in equipment and software** is growing at double-digit rates, on a par with the celebrated investment boom of the late 1990s. Forward-looking data on **new orders for nondefense capital goods excluding aircraft** are growing at high single-digit rates, also much in line with the late '90s experience. At the same time, the market for growth-critical **risk capital** remains robust, with **high-risk credit spreads** remaining in a range around 350 basis points. Were growth prospects to turn sour, this would be one of the first indicators to show it.

Bottom line: The suggestion that the Fed has already become restrictive enough to dampen expected returns, and threatens to cause considerable damage with further action, suffers from a lack of logical or empirical support. To the contrary, the price of **gold** and other market-sensitive **inflation indicators** suggest the real risk would be a Fed that calls a too-early end to the policy normalization process, as an unexpected uptick in core inflation would inevitably be met with an aggressive policy response. At this point, and as fully detailed in yesterday's report, that is not the outcome we anticipate. At the same time, as longer-term yields have been kept in check by a real funds rate that remains low by historical standards, we expect to see yields rise across the curve as the Fed pushes short rates higher than markets are currently anticipating.
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