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How Much More?

Thursday, April 13, 2006

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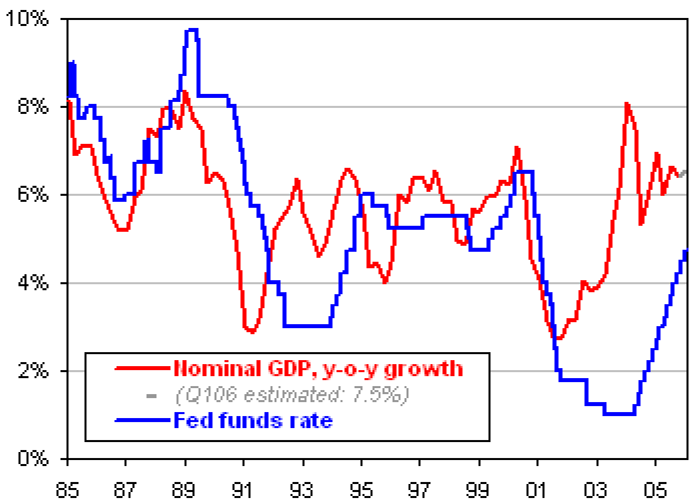
The equilibrium interest rate has moved higher -- so the Fed has much further to go than the market expects.

In a report last week, we suggested that while the latest pop higher in **gold** and other sensitive **commodity prices** probably was not directly attributable to **monetary causes**, there's little doubt that these market prices indicate that **the Fed** remains in an **accommodative** posture (see "Gold, the Dollar, and the Fed" April 3, 2006). If the Fed had reached **policy equilibrium**, restoring **balance in the supply and demand for dollar liquidity**, the price indicators -- especially gold -- would at least reflect an unwinding of the **inflation risk premium** which we see as having been a significant factor in the gold price run-up of the past few years.

But after 375 basis points in **rate hikes**, and amid **market expectations** pointing to a growing likelihood of at least 50 bps more in the coming months, there remains little -- if any -- evidence suggesting that either policy or policy expectations are approaching the zone of **"neutrality"** that the Fed has been seeking for nearly two years. It appears that a basic **mismatch** between dollar supply and demand remains intact, continuing to feed a liquidity surplus.



We have referred on several occasions to the relationship between the **fed funds target** and **nominal GDP growth** as a handy reference to the relative **ease** or **tightness** of policy. With nominal growth serving as a proxy for **economy-wide available returns**, the position of the funds rate relative to those returns captures an important element of the policy dynamic. When the Fed is holding the funds rate at levels below available returns, as it is now, **incentives to borrow at below-market rates** push up on the overnight rate, compelling the Fed to **inject** additional liquidity to maintain the target. While nominal GDP growth is a convenient analytic tool for these purposes, it's a static, backward-looking indicator that tells us nothing about contemporaneous shifts in growth expectations that obviously can have an important bearing on **expected returns**. It appears that a significant shift up in the market's **growth outlook** in the past couple months has effectively kept the Fed from moving closer to equilibrium, even as it raised its target by 25 bps in the interim. In other words, the **equilibrium interest rate** is a moving target -- and it has moved higher.

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The market's rising growth expectations have been reflected across a range of **asset prices** the past two months, perhaps most clearly in **Treasuries**, where the **10-year yield** has jumped by some 50 basis points to just above 5% since mid-February. The jump in yields has corresponded with, and has to a considerable degree been explained by, a recalibration of the market's out-month expectations for the extent of this Fed rate-hiking exercise. Those recalibrated expectations, of course, also reflect considerably more robust growth prospects than had been evident earlier. As we noted on several occasions, **long-term bond yields** were being held in check -- culminating in the **yield curve inversion** of February and early March -- by a conviction in the market that the **economic braking effects** of Fed rate hikes would force the central bank into **rate-cutting** mode soon after it concluded a foreshortened **rate-normalization cycle** (see "Return of the Long Bond" February 10, 2006). We persistently refuted that rationale, contending that a vibrant economic environment would keep rates higher longer than the market was anticipating (see "Learning Curve" March 21, 2006). The rising yields of recent weeks represent confirmation of that contention.

Were the **overnight inter-bank lending rate** a **free-floating market rate** not under the control of our monetary central planners, it would undoubtedly have responded to the same market forces pushing longer-term yields higher. If it weren't bound by the inefficiencies of the **rate-targeting process**, the Fed could adopt a policy regime under which it adjusted the availability of liquidity so as to directly affect **dollar purchasing power**, using a **price rule** approach, for example. As it is, however, the flawed rate-targeting mechanism -- bound by the fact that the rate is set by meetings of policymakers only once every six to eight weeks -- can put policy further **behind the curve** even at a time, such as now, when it is ostensibly moving to catch up.

We noted last week that under certain measures, growth of the Fed's **balance sheet**, *i.e.* the **asset base** mirroring the provision of liquidity to the market, has slowed markedly since initiation of this policy cycle in mid-2004. On a four-week moving average of a 13-week annualized rate, for example, the balance sheet actually is currently showing a **slight contraction**. A more telescoped view of the data, however, suggests that the higher growth prospects reflected in market rates has shown through to the Fed's **open market activities** by compelling a more generous liquidity posture. In the first six weeks of the year, the balance sheet on net was essentially **unchanged**, with the **open market desk** having drawn down the extra liquidity customarily built up to meet demand during the year-end holiday season. What is most telling, though, is that in the eight weeks since -- which is the period corresponding with yields rising in accord with an enhanced growth outlook -- annualized balance sheet growth has **accelerated** to nearly 10%.

Were there evidence of money demand rising concurrently, this increased liquidity flow would be of little moment. Quite the contrary, however, appears to be the case. **MZM**, the Fed's broadest measure of immediately available funds, grew at an annual rate of about 3.5% in the first quarter. We estimate that the **first quarter GDP** release coming out late this month will show a nominal GDP growth rate on the order of 7.5%. That means **velocity**, a measure of the demand for money relative to the goods for which it exchanges, is continuing to rise, an indication of declining money demand. As it is, velocity growth has been running at 10-year highs around 4% for the past year. By contrast, early in this decade at the height of the **monetary deflation** -- a phenomenon marked by excess money demand -- velocity was falling at double digit rates. During the deflation, heightened demand for money was a product of the Fed's massively **too-tight policy** stance, which created an environment in which **money** offered the best rate of return available in the market. Now, with the Fed continuing to target a rate below **market-clearing** levels, the still-softening demand for money is a function of the rising **opportunity costs** of holding **monetary balances**.

Key questions now, of course, concern how much further the Fed needs to go to restore equilibrium, and the extent to which policymakers recognize that the task remains incomplete. We think it's entirely plausible to put an equilibrium rate in this environment in the realm of 6%, a level which, based on the past relationship between nominal GDP and the funds rate, we believe would represent little risk to continued **healthy expansion**. At this point, however, there seems to be a growing diversity of views among policymakers, with some apparently believing policy is at or close to attaining the objective of neutrality, while others see such declarations as being premature. One long-serving member of the policy committee, **St. Louis Fed president William Poole**, told us this week that he sees policy risks at this point as "asymmetric" on the side of inflation. He suggested to us that he's willing to risk erring on the side of restraint, because the costs of an **inflation error** would be considerably higher than the costs of correcting for a **rate-hike overshoot**. The degree to which Poole represents consensus within the policy panel at this point is difficult to know with any precision, but it's probably a safe bet that the **new chairman, Ben Bernanke**, is closer to Poole's view than to those suggesting policy normalization is at hand. As we've suggested, in the early stages of his tenure Bernanke is likely inclined to take steps to hone his **anti-inflation credentials**.

BOTTOM LINE: Despite having raised rates by 375 basis points in this policy cycle to date, there is yet little evidence that the Fed is nearing the point of reaching policy equilibrium. Indeed, there is good reason to believe that the recent improvement in growth prospects has actually put the Fed further behind the curve, as a consequence of the funds rate target failing to keep up with available returns. While the market is now fully priced for a 5.25% funds rate by this summer, we see more than two additional rate hikes as likely being necessary to complete the Fed's mission, and believe the **FOMC** is coming around to that view as well. TM