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The Hawk Has Landed

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We can finally see the end of this rate-hiking cycle -- in time to address inflation risk without damage to growth.

The equity market's heartening enthusiasm of the past two sessions in the face of rising interest rate expectations reinforces our view that the conventional wisdom on the past month's sell-off -- fear that the Fed would choke off growth with further rate hikes -- was hardly telling the whole story. While the risk of overshoot cannot be dismissed out of hand, the Fed's overnight target rate at these levels poses little threat, and at this point it seems a good bet that the Fed will conclude this tightening exercise before that Rubicon is crossed. In fact, the recent no-nonsense rhetoric of key Fed officials on the inflation front has significantly buttressed confidence in the dollar, suggesting rates might not have to rise as much they would have otherwise. All in all, it seems that the makings of a highly positive scenario are coming into view, with the Fed taking expeditious enough action to root out the inflationary impulses of its long-standing excessively easy posture -- and thereby actually reducing risks to the durability of this expansion. This constructive outlook may well be the framework for realizing the buying opportunity in stocks presented by the sharp downdraft of the past several weeks, as we have been patiently expecting throughout (see, for example, "Coming Home to Roost" May 18, 2006). .

Update to strategic view

US STOCKS: The last month's sharp decline continues to emerge as a buying opportunity as it becomes clear that the Fed can root out inflation risks without rates so restrictive as to damage economic growth.
FED FUNDS: Two more rate hikes at the next two FOMC meetings, then this tightening regime is likely to end at 5.5%.
US MACRO: The present rate-hiking cycle is likely to conclude soon at 5.5%, a level not so restrictive as to damage economic growth.

[see Investment Strategy Dashboard]

It may seem paradoxical, but a key to this encouraging turn of events has been the recent jump of core consumer price inflation to a higher plateau. We have long viewed it as inevitable that the surplus liquidity of recent years -- as seen most vividly in the price of gold and other commodities, as well as the decline of the dollar's forex value -- would eventually show through in accelerated statistical inflation. But with its demand-based conception that views inflation as a function of real factors such as "resource utilization," the Fed had no reason to think core inflation was headed above the 2% top of its "comfort zone." Even before yesterday's core CPI showed a third consecutive monthly 0.3% increase in May -- a 3.8% three-month annualized rate -- it was clear from the comments of chairman Ben Bernanke and other key Fed figures that the price data was imparting a significantly more hawkish perspective (see "Bernanke Arrives" June 6, 2006). In the 10 days since Bernanke's speech citing the "unwelcome developments" in core inflation, not only have futures priced for the certainty of a 5.25% funds rate coming out of the June 29 FOMC session (versus less than a 50% chance prior to the speech). Now August futures show a nearly 90% probability of a 5.5% rate at the subsequent meeting.

Critically, this shift in the expectations setting has been met by a marked improvement in the most forward-looking market based indicators of dollar purchasing power, with the price of gold dropping about $70 to around $570. Since topping out above $720 in early May, gold has traversed about half the distance back to a level in the low $400s that would indicate the Fed has absorbed its inflation error. From here, signs of further progress could prove difficult pending confirmation that the Fed is committed to following through on these signals with actual rate action. At the same time, though, the response of market price indicators also suggests that, in restoring a measure of confidence in its commitment to secure the dollar's value, the Fed may have less to do to demonstrate that commitment than would have been the case absent the hawkish remarks. In other words, the comments of Bernanke and other Fed officials suggesting a heightened inflation vigilance have in themselves gone some way toward rebalancing the supply and demand for dollar liquidity, leaving less that need be done through higher rates alone.

Based on the response of the market indicators to changing Fed expectations, we see a growing likelihood that the Fed will reach equilibrium with a funds rate target no higher than 5.5%. After two years of opposing a persistent consensus that this cycle would end both imminently and at restrictive levels, for the first time we can finally see its conclusion nearing -- but at levels that would present very little real risk to sustaining a vigorous economic environment. Consider that since 1984, the funds rate has averaged that same 5.5%, while real four-quarter GDP growth has averaged 3.4%. At this point, we can't rule out the possibility that the Fed would stay in rate-hike mode beyond a level that would punish growth, given the likelihood that core inflation will remain at relatively elevated levels for some time to come. However, we read the Fed's recent hawkishness primarily as an effort to keep inflation expectations in check in light of the trend higher in core inflation. As long as inflation expectations continue to follow the course seen recently in gold, commodities, the dollar and bond spreads, we see the Fed as unlikely to get tight enough to pose a real risk to growth.

BOTTOM LINE: The equity market's strong rally yesterday was attributed by some to "somewhat dovish" comments by Ben Bernanke in a mid-afternoon speech on energy prices, notwithstanding that about half the day's gains were already booked by the time Bernanke's remarks were released. The comments that supposedly fit the "dovish" description came in Bernanke's observation that inflation expectations reflected in the difference between nominal and inflation-indexed Treasuries have "fallen back somewhat in the past month." However, the narrowing of that spread, as Bernanke well knows, has come as a consequence of the more hawkish notes that have come from the central bank in the past several weeks, beginning with the statement released following the May 10 FOMC meeting. During the speech, the Fed chairman also noted that such gauges of inflation expectations "have edged up, on net, in recent months." And if Bernanke was intending to send any message of dovishness, it went right over the head of the credit markets, where expectations of forthcoming Fed action were entirely unmoved by his remarks. Our take is that after a bout of anxiety, the stock market is coming to the recognition that this economy shows every sign of maintaining a vigorous pace of expansion, and that the Fed's most likely policy course represents no threat to that outlook. TM