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Data Delusions for Doves

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The Fed will spin this week's numbers to stay sidelined, but a closer look reveals continued growth and inflation.

Update to strategic view

FED FUNDS: A "data dependent" Fed seems to have what it needs to stay on hold at the September FOMC meeting. But probably as soon as the October meeting, evidence of economic acceleration and rising inflation will challenge the Fed to take up rate-hikes once again.

[see Investment Strategy Dashboard]

Barely a week since the FOMC sanctioned at least a break in the policy normalization process, markets have taken the latest stream of data releases as signaling that the Fed is likely to remain on hold indefinitely. Given the dovish stance taken by the panel last week (see "Surprise on the Doveside" August 9, 2006), we would agree that that is probably an accurate assessment of the current policy outlook. But we are entirely unconvinced that the data point either to a short term diminution of inflation pressures or a significant slowing in the pace of growth, both of which the Fed is relying on as rationales for standing pat. After no more than another meeting or two, we expect the Fed to be back in the rate-hiking business, and with considerable catching up to do to compensate for the ground lost in its ill-advised retreat to the sidelines.

It's not terribly surprising, we suppose, that markets attempting to deal with an avowedly "data dependent" Fed would respond so sharply to inputs as sketchy as monthly economic data points. The central bank is inviting such overreaction by itself being guided to great extent by these statistical dollops, which can be highly misleading in gauging the progress of policy in reaching equilibrium after several years in a highly accommodative mode. The fuse under the current bond rally, which has seen the benchmark 10-year Treasury yield drop from 5% to 4.86% since Monday, was lit by yesterday's July Producer Price Index release, which showed a 0.3% decline in core PPI. The PPI has a weak track record as a leading indicator of changes in the overall price level, and is highly volatile on a month-to-month basis. Thus far this year the core PPI has registered monthly changes of 0.4%, 0.3%, 0.2%, 0.1%, 0.3%, 0.2%, and yesterday's -0.3%. By no means do we put great store in the monthly blips of the *Consumer* Price Index, but it at least has shown less skittishness than the *producer* price data, with core CPI posting four consecutive monthly changes of 0.3% prior to today's 0.2% reading for July. And any notion that the reduction in core PPI reflects some broad-based rekindling of a disinflationary trend is refuted by the fact that the decline was more than fully explained by the drop in car and light truck prices.

Bonds today are building on yesterday's better than half-point gains with another round of data widely interpreted as pointing toward both lower inflation and slower growth. The 0.2% increase in core CPI, however, can hardly be considered a departure from recent trends. Although on a monthly basis the change in the index fell by a tenth of a point, year-to-year it was *up* a tenth, and at 2.7% the 12-month increase is the highest in five and a half years. We maintain that core inflation will continue to move higher, with a 3 handle on the year-to-year rate likely appearing

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before year end as the price level moves to equilibrate with the loss of dollar purchasing power seen for the past three years in sensitive market indicators including gold and foreign exchange.

A below-consensus gain of 0.4% in July industrial production was seen as another feather in the doves' caps, but we view that as a misreading of the data. Excluding motor vehicles, production was up 0.8% last month, and there are ample signs in the data that the supply side of the economy is accelerating. Business equipment output rose 1.5% last month and is up 12.2% in the past year. This is the manifestation of a capex surge being effected by enterprises that continue to see bright skies ahead and in fact are going a long way toward making it happen by expanding the economy's productive capacity.

Meanwhile, those dour sorts expecting the economy to run into a ditch any day now due to the long-awaited housing depression took heart from the report today showing that housing starts fell another 2.5% last month. It's worth noting, however, that even with starts having fallen in five of the past six months, they remain at an annual rate of nearly 1.8 million, which is still some 20% above the levels that largely prevailed from the mid-1990s through the first couple of years of this decade. It was inevitable that the housing market would moderate once the support of artificially low interest rates was withdrawn. But we see nothing to support the notion that the market is poised for collapse or that a cooling in housing represents the leading edge of a forthcoming recession.

BOTTOM LINE: Financial markets, especially fixed income, have taken wing on the idea that growth is slowing enough and inflation appears tame enough to keep the Fed out of the picture. The markets want to believe that the Fed's Phillips Curve/output-gap paradigm, in which inflation is a function of economic growth, will prevail -- and with the pace of expansion apparently cooling, the Fed will have no reason to return to action. In the fullness of time, this is likely to go down as a serious misjudgment. As an inflation forecasting tool, the Phillips Curve has gotten it wrong time after time, while the market price model we use has repeatedly proven its validity. Besides, while the markets are counting on an economic slowing to continue providing the Fed with the cushion it needs to stay sidelined, from our perspective the growth outlook appears strong. At some point in the not too distant future, the Fed will unavoidably be forced to take more action to raise rates than either it or the markets are now anticipating. TM