TrendMacrolytics

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What Landing?

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An unexpectedly strong economy is set to disappoint the bond market on the upside.

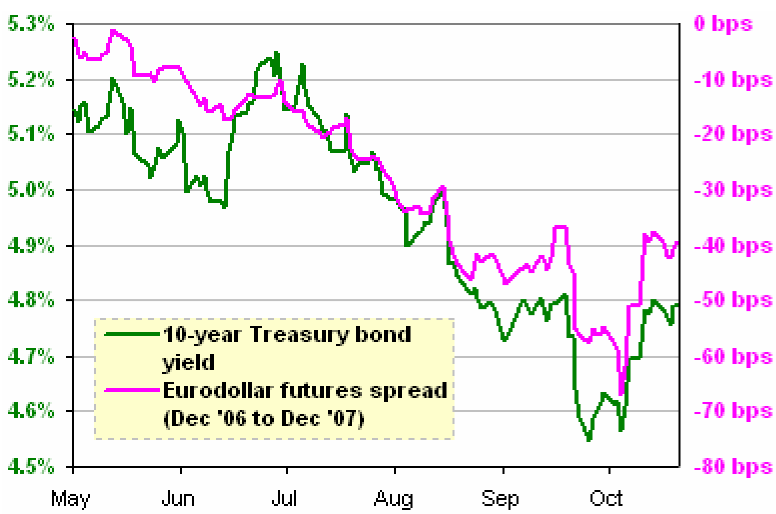
The worst of the "hard landing" slowdown expectations that barely two weeks ago had the credit markets pricing for as much 75 basis points in Fed rate cuts have markedly unwound. Now it's the nearly unanimous view of the economic cognoscenti that the economy is heading for a fabled "soft landing." For the moment, this agreement is keeping bond yields, which have jumped nearly 25 basis points from their recent lows around 4.55%, from continuing to shoot higher. The market is retaining a rate cut bet, but rather than discounting for between two and three 25 basis point cuts next year, it now sees between one and two. But that is also likely to prove unsustainable, as the pace of this economic expansion shows few signs of decelerating toward levels that would have the Fed even consider an easing response.

Update to strategic view

US BONDS: Well off their lows, Treasury yields have begun to absorb the reality that the Fed will have no motive to lower interest rates. The next step is for growth well above the bond market's bleak expectations to trigger a wholesale shift in consensus, pointing to the next rate move by the Fed to be a hike.

[see Investment Strategy Dashboard]

Throughout this growth cycle -- the origins of which we date to the second quarter of 2003 in conjunction with enactment of the tax cuts on dividends and capital gains -- conventional wisdom has seen economic misfortune lurking around nearly every corner, whether the culprit is the "twin deficits," rising energy prices, falling savings, cratering housing, or higher interest rates. We, however, have stuck with first principles, understanding that the incentives to risk-taking and capital formation spurred by the tax cuts laid the foundations for a self-sustaining long-running expansion which would only be put at risk by significant policy error. We have also identified the source of that potential error in Fed monetary policy, but to this point a still accommodative Fed has actually been growth-supporting.



10-YEAR BOND YIELDS ARE STILL TIED TO FED EXPECTATIONS

The slowdown fears appear to have been prompted to considerable extent by a basic confusion between the normal ebb and flow of data and a weakening of underlying conditions. In the past three

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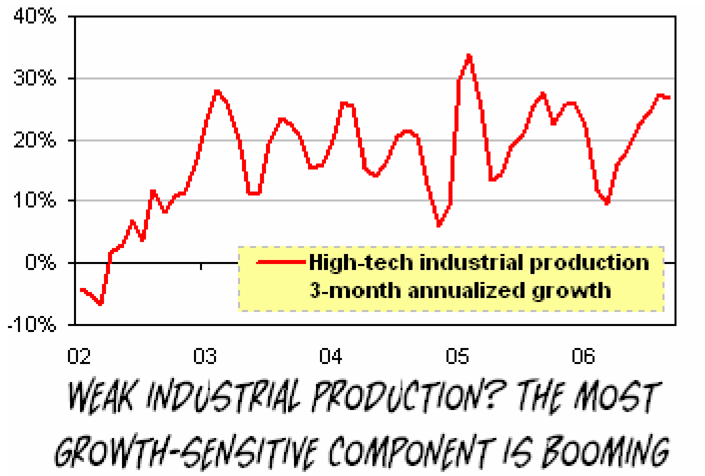
months, for example, new orders for durable goods have slowed to an annual growth rate of about 1.3%, down from a 3-month annualized rate of more than 20% this past spring. This durable goods decline is a factor in some Wall Street forecasts pointing to growth coming in at a sub-2% rate in the third and fourth quarters. But durable goods is a notoriously volatile series, and such swings are more the rule than the exception. For example, since mid-2003, real GDP growth has averaged about 3.5% -- but there has been a negative 3-month annualized rate for durable goods orders posted on seven separate occasions. Moreover, the segment of durable goods orders with the most forward-looking growth properties -- non-defense capital goods excluding aircraft -- is growing at a strong 3-month annualized rate of about 8%.



Other indicators of the status of capital formation are equally positive. While overall industrial production has been somewhat sluggish the past couple months, business equipment production is showing an 8.2% annualized growth rate the past three months, while the high-tech field of computers, communications equipment and semiconductors is booming at 3-month annualized growth approaching 30%. This data strongly suggest that expected available returns remain robust enough to support the commitment of investment resources to continued expansion of the capital stock, which represents augmentation of the economy's income-producing capacity. In this way, strong growth expectations -- rooted in pro-growth tax policies and non-obstructive monetary policy -- support entrepreneurial risk-taking and become self-fulfilling. And on the front lines of risk preference, we note that the Merrill Lynch high-yield credit spread is now running below 320 basis points. That is a level that has always been consistent with solid growth, evincing no trace of an increase in default risk that would be expected if the growth outlook was dimming in any fundamental way.

Meanwhile, retail sales continue to surprise on the high side, as the long-anticipated demise of "the consumer" is a shoe that refuses to drop. Real personal consumption growth appears to be on about a 3% track, up from 2.6% in the second quarter. In our model, consumption is the reward for production, so it is properly viewed as the effect, not the cause, of output growth. But the continued buoyancy of consumer spending is another indication that the purportedly looming threats to growth remain impotent.

All in all, conditions appear to augur for a reported real growth rate of at least 3% when preliminary third quarter GDP is released next week. There is, however, one fly in the ointment of the Commerce Department's statistical machinations. Strong domestic expansion is also driving up import growth, resulting in record trade deficits, now running at nearly $70 billion per month. While we view such a "trade imbalance" as an entirely benign consequence of solid growth -- obscuring the fact that it has also been accompanied by record export levels -- the GDP tables record a rising trade deficit as a decline in "net exports." This could shave more than half a percentage point from the reported GDP growth rate, bringing it below 3%. Such a statistical convention may make good fodder for protectionists, but it reflects no deleterious influence on the actual state of the economy, or the prospects for continued growth. Indeed, given the recent decline of oil prices, it's entirely possible that the trade balance will be recorded as growth-positive in the fourth quarter.

The economy's ability to sustain a robust pace of expansion is likely to be viewed with some consternation at the Fed, but actually it will end up making the remaining monetary task less problematic than it would be otherwise. Under the output gap model guiding the central bank, it has been counting on a "moderation" in growth to quell inflation pressures and allow it to remain on hold with a 5.25% funds rate. The Fed's forecasts infer a second half growth pace of little more than 2%. So, the stronger than expected growth is likely to be a factor pointing policymakers toward the need to return to rate-hiking mode. But the fact is policymakers will inevitably be compelled at some point to resume lifting rates because inflation will continue to press higher, regardless of growth. It's not yet clear how high rates would have to rise, that being to no small extent a function of when the Fed comes off pause. At the moment, our sense is that the equilibrium funds rate is 6% or higher (see "The Price of the Pause" October 20, 2006). We are concerned that at some point and at some level, the equilibrium rate will be high enough to cause significant harm to the economy. But it's far preferable for the Fed to be moving back into a tightening posture with a solid growth backdrop than if the economy were heading into a funk.

BOTTOM LINE: The "hard landing" scenario that had captured the bond market and inspired expectations of a fairly aggressive course of Fed ease has receded, but prospects for a slowdown, under the guise of a "soft landing," remain the popular choice. But it's becoming difficult to identify indicators supporting the notion that the economy is fundamentally slowing. Investment remains strong, consumption is actually rising, and the entrepreneurial risk-taking spirit shows no signs of flagging. Credit markets still likely face the bulk of an unwelcome two-stage reckoning, first when it becomes clear that the remaining bet on Fed rate cutting will not pan out, and then as it becomes apparent that the next move will mean higher -- not lower -- rates.