TrendMacrolytics

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

MACROCOSM

New Year, New Day?

Thursday, January 4, 2007
David Gitlitz

But the Fed keeps the same hawkish bias, and bond markets still won't listen.

The string of better than expected data releases that have come out in the past few weeks has taken a toll on the widespread economic pessimism that had prevailed. But the consensus is clinging to the conviction that lower interest rates remain nearly certain. Continued strength in incomes and consumption, backed by a tight labor market amid growing signs of a stabilizing housing sector, would not appear to strengthen the case for the Fed moving into easing mode. Nevertheless, futures markets are still priced for more than 50 basis points in rate cuts this year, with an odds-on bet that the first move comes before the end of the first half. We continue to see compelling opportunity in taking the other side of this bet, believing it more likely that the Fed will be raising rather than cutting rates at some point in the first two quarters.

The seeming incoherence of the consensus view was aptly captured this week in the *Wall Street Journal's* semiannual economic forecasting survey. Despite forecasting that the economy will show progressively greater strength in each quarter, posting a 2.9% growth rate in the fourth, the average projection of the 60 economists polled by the *Journal* is that the funds rate will drop to 5.01% by June and 4.83% by year end. But we think it's a safe bet that without a significant growth slowdown, the rate-cutting option will simply not be on the Fed's agenda. In fact, even abstracting from what we see as a very real potential for a reacceleration of core inflation, real GDP growth in excess of 2.5% -- which the *Journal* consensus expects by the third quarter -- would likely be sufficient in itself to shift the policy nexus back toward raising rates.

Update to strategic view
US MACRO: Data continues to show growth reaccelerating. Yesterday's slightly bearish FOMC minutes document a meeting held prior to much of the recent evidence of resurgent growth. **FED FUNDS:** The consensus for 2007 growth is too low -- but even at consensus, growth will be to fast for the Fed to cut rates as the markets still expect. The next rate move is higher -- the only question is when, over the coming two quarters. **US BONDS:** Bonds are rallying on a single bearish sentence from yesterday's FOMC minutes, and hopes of a poor jobs report tomorrow. But the minutes document a meeting held prior to much of the recent evidence of resurgent growth, and the jobs numbers have become so unreliable that only a downside blow-out could sustain bearish expectations of bond bulls.
[see Investment Strategy Dashboard]

While it's conveniently overlooked by the bond bulls and economic bears in framing their easing calls, fact is the central bank is maintaining a tightening bias. Release yesterday of the December 12 FOMC minutes served again to underscore the reality that inflation continues to be the primary policy concern. "All meeting participants remained concerned about the outlook

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
704 552 3625

Copyright 2007 Trend Macrolytics LLC. All rights reserved. This document is not to be forwarded to individuals or organizations not authorized by Trend Macrolytics LLC to receive it. For information purposes only; not to be deemed to be recommendations for buying or selling specific securities or to constitute personalized investment advice. Derived from sources deemed to be reliable, but no warranty is made as to accuracy.

for inflation," the minutes said. "Although readings on core inflation had improved modestly since the spring, nearly all participants viewed core inflation as uncomfortably high and stressed the importance of further moderation." While core inflation is expected to move lower over time, "participants stressed there was considerable uncertainty as to the probable pace and extent of the moderation in core inflation and that the risks around this desired downward path remained to the upside." Press coverage of the minutes drew considerable attention to one sentence in the record which suggested some degree of concern that "downside risks to economic growth in the near term had increased a little and become a bit more broadly based than previously thought." But the December meeting came prior to release of the more upbeat indicators, and the minutes reiterated that "all members agreed that the risk that inflation would fail to moderate as desired remained the predominant concern."

Persistence of the belief that rate cuts are coming -- despite what the Fed is currently saying -- is based to some extent on the experience of the last rate-hiking cycle in 2000. After hiking rates for the final time that spring, the Fed maintained its tightening bias through the rest of the year even as signs of slowing growth mounted. The first week of 2001 was marked by a surprise inter-meeting 50 basis point cut, the first move in what was to end up cumulating to 550 bps in cuts over the next two and a half years. The major difference between then and now, however, is that in 2000 there were clear indications that policy had gotten too tight. Now, there are no such indications. The price of gold, on net, had fallen from above $310 to around $265 between spring 1998 and late fall 2000, and over the same period the CRB spot commodity index dropped more than 20%. In this cycle, by contrast, gold has soared from below $400 in mid-2004 to around $625, with CRB spot gaining about 24% over the same period. Perhaps the most compelling comparison is in credit spreads, with the Merrill Lynch high-yield spread -- at below 300 basis points -- now challenging its best levels of the late 1990s, rallying by some 80 basis points just since September. This is an indication both that growth prospects remain robust and that the Fed is still accommodative. Had the Fed gotten policy to a position that could in any way be considered "tight," default risk would be showing up in a widening of this spread. That's exactly what happened in 2000, when the high-yield spread blew out by some 450 basis points, as the Fed's deflationary stance mercilessly pounded debtors and decimated supplies of risk capital indispensable to sustainable growth.

The lynchpin for the economic bears has been the proposition that the impact of higher rates on the housing market would inevitably, through wealth effects, penalize consumption and pull the rest of the economy down with it. We have consistently rebutted that theory, pointing out that the real estate wealth effect explained a small part of consumption growth even during the housing boom, and characterizing housing as experiencing a normal correction with rates moving toward normalcy from the ultra-low levels that had prevailed the previous few years. Historically, we noted, sharp sustained declines in housing were a consequence of serious economic downturns, while the reverse occurrence -- a housing correction leading to a generalized economic downturn -- has no precedent in economic history. Now, not only are the bears facing the specter of consumption growth actually accelerating -- the fourth quarter is on pace for a 4%-plus gain in real personal consumption, up from less than 3% in the third quarter -- more and more signs are pointing to at least a bottoming of the housing downturn, with some indicators suggesting the beginnings of a recovery could be in the works. All in all, the bearish case appears to be withering away, as it now appears that the third quarter will stand as the peak of the housing downturn and its drag on reported growth.

BOTTOM LINE: Despite the steady accumulation of data suggesting the economy is not nearly weak enough to support the expectations for Fed ease now priced in fixed income markets, hope springs eternal for bond bulls. Today, bonds are rallying to pull the 10-year yield back toward 4.6% on the hope -- supported by a private estimate that has had a woeful record for accuracy over the past several months -- that tomorrow's employment data will reflect a turn

toward labor market weakness. While we can't rule out the possibility of a counter-trend data point, especially with the initial payrolls estimates being as volatile and inaccurate as they've proven to be, this economy going forward is likely to continue surprising on the upside. Many estimates for growth in the current quarter recently were running below 2%. Now, it appears a 2.5% to 3% quarter is in the works. Time appears to be running out on the bullish case for bonds. TM