TrendMacrolytics

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TRENDMACRO LIVE!

On GDP and FOMC

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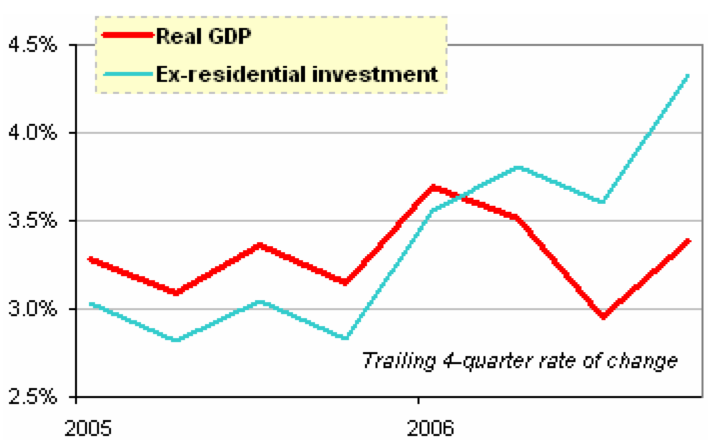
The amazing resilience and flexibility of the US economy is rapidly thinning the ranks of the pessimists and naysayers that up until so recently typified the economics mainstream. We'll enjoy a moment of "we told you so" satisfaction on the confirmation that the economy, in posting a 3.5% fourth quarter growth rate, registered an upside surprise even on top of the hastily recalibrated consensus that poked above 2% only within the last several weeks. Already, though, what happened last quarter is yesterday's news. We have little reason to doubt that the economy is capable of sustaining such robust performance. The live issue, however, now becomes whether the Fed awakens to the reality that prospects for such sustainability are enhanced more by an early return to the process of restoring monetary equilibrium than by remaining sidelined until it's too late to rectify its inflation-biased stance without putting the expansion at severe risk.

We see today's FOMC statement as representing a marginal shift in the right direction, incorporating recognition of "somewhat firmer growth" and "tentative signs" of stabilization in the housing market, following the December \statement underscoring that "growth has slowed…partly reflecting a substantial cooling of the housing market."



For a policy panel that had put considerable store in the notion that the housing slump represented a damper on the overall economy, today's data had to be an eye-opener. While the direct effect of the decline in residential investment was nearly as great as the third quarter's 1.2% drag on growth, performance excluding housing was nothing less than stellar. For the quarter, the growth rate ex-housing was

Update to strategic view

US MACROECONOMY: The fourth quarter's stellar growth demonstrates that, even with residential investment showing almost no improvement, the housing cool-off is not infecting the rest of the economy.

FED FUNDS: The FOMC today made a modest acknowledgment of faster growth, but remains behind the curve as the economy surges ahead more rapidly than the Fed's perceptions. We continue to see the funds rate on hold for the foreseeable future, but expect the next move to be higher as continuing growth and rising inflation expectations command the Fed's attention.

[see Investment Strategy Dashboard]

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4.8%, while for the year it was 4.3%. By the same token, the four-quarter growth rate of 3.4% exceeded the 3.1% of 2005 which, under the Fed's demand-based output-gap model, already exceeds the estimate of somewhat less than 3% posited as representing non-inflationary "potential growth." One rationalization for the Fed remaining on hold -- the supposed restraint on growth posed by the lagged effects of the earlier rate hikes -- has apparently been rendered moot, and was dropped from the statement.

Moreover, the committee maintained its tightening bias, and noted that "some inflation risks remain." We'd note that while the press coverage paid considerable attention to the headline GDP deflator dropping to 1.5% from 1.9% in the third quarter, this was primarily an oil price effect. The core GDP deflator rose from 2.2% to 2.3%. On a four-quarter basis, the growth rate of nominal GDP barely budged, and at 5.94% remains at levels leaving the Fed in an accommodative posture with its overnight rate target at 5.25%.

Still, the FOMC was moved to note that "readings on core inflation have improved modestly" and to issue its standard assurances that "inflation pressures seem likely to moderate over time." At the same time, with the new year and a new lineup of regional reserve bank presidents taking committee votes, the dissent that had been registered by Richmond Fed president Jeff Lacker to the decision to remain on hold the past several meetings was not taken up by any of the new voters. All this was enough to give the bond market reassurance that while the overall sentiment of the committee may appear marginally less dovish, there's little at this point motivating the Fed toward any change in approach. On that score, we also take our cue from the gold price, which in the wake of this morning's above-expectations GDP print, proceeded to rally by upwards of $8 to above $650 for the first time in more than six months --taking most other commodities with it, as the dollar moved lower. These inflation-sensitive markets, it appears, are willing to bet that somewhat faster growth is not likely to move the Fed closer to resuming its rate hiking exercise, which in essence only puts the Fed further behind the curve.

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