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Hawk Spotting

Monday, February 12, 2007

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Bernanke's testimony this week should end all doubt that the next Fed move is to higher rates.

> **Update to strategic view**
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> **FED FUNDS:** We expect Bernanke's testimony before congress this week to affirm what an array of Fed speakers all said last week -- that inflation is still too high, and that growth is potentially too rapid. This should finish off any residual hopes that the Fed will cut the funds rate in 2007, and may presage a return to rate hikes as soon as the May FOMC meeting. **US MACRO:** As robust as fourth quarter GDP growth was, recovery in several areas of reported weakness creates the opportunity for even more robust growth in the first quarter of 2007.
>
> [see Investment Strategy Dashboard]

The consensus has gradually and grudgingly come to accept that the prospect of lower rates has been relegated to the status of forlorn hope. But die-hards have refused to surrender, even managing to find some rationale for keeping rate cut hopes alive in the FOMC's post-meeting statement at the end of January. The rally that since then had taken the 10-year yield from nearly 4.9% to below 4.75% came to an abrupt end late last week, however, when a round of appearances by Fed notables underscored that policymakers at this point, far from entertaining any notion of easing, continue to see a return to rate hikes as very much a live option. We see this as preparatory to Fed chief Ben Bernanke's congressional testimony starting Wednesday, which we expect to show hawkish enough leanings to sharpen the market's focus on the real possibility of the Fed moving back into tightening mode.

Among the four regional reserve bank presidents speaking last week, varying degrees of either concern or satisfaction with current conditions were expressed. But a couple of bottom line suppositions emerged as common to all of them. For one, the prospect of keeping the funds rate on hold at 5.25% depends on seeing core inflation move steadily below the 2% plateau. Probably at least equally important, recent contemporaneous signs of accelerating growth are viewed with considerable caution. Indications of growth being sustained at 3%-plus rates would be seen as "excessive" and met with policy restraint.

On both of these fronts, we think the central bank will be faced with little choice but to resume its rate hiking exercise, and possibly fairly soon (see "Chairman Bernanke's Year of Living Dangerously" February 8, 2007). Skepticism that recent signs of moderation in core inflation will be sustained was clear in the comments of Philadelphia Fed president Charles Plosser, who noted that "While we got some encouraging inflation numbers toward the end of last year, I am not convinced that underlying inflation is on a downward trend." Plosser said it's possible that the recent deceleration will continue, but "I believe it is too soon to declare victory." Similarly, Sandra Pianalto, president of the Cleveland Fed, said she's not convinced underlying inflation

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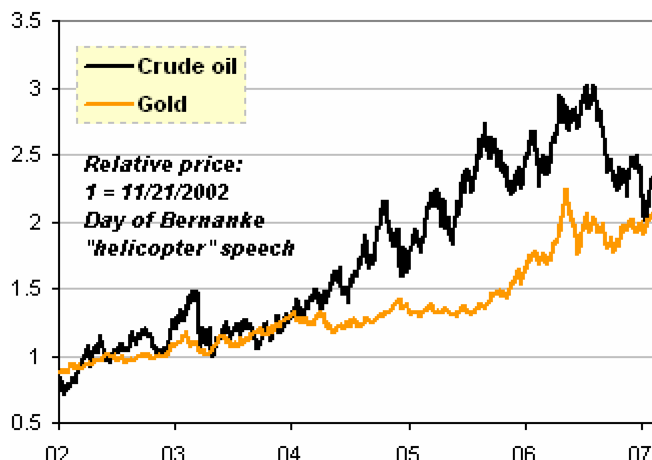
has moved lower. "The national inflation picture has been clouded in the past few years by large swings in energy" and other commodity prices, Pianalto said. "As these markets normalize, and as we gain a clearer picture of the underlying inflation trend, we may see that some inflation risks remain," and additional firming may be needed.



Indeed, the recent slowing in the statistical inflation indexes has been attributable to considerable extent to the better than $25 per barrel decline in crude oil prices from last August through the middle of last month. As we suggested though, this price break represented less a slackening of inflation pressures than the correction of an unsustainable speculative surge (see "Commodities: Don't Be Fooled" January 12, 2007). At that time, we noted that oil appeared to be reestablishing its equilibrium relative to the price of gold, the most inflation-sensitive of all commodities. In the past month, oil prices have rallied back by about $7 and gold is up some $35 to above $660, a level not seen since last July, and as suggested by the chart at left, a rough linkage between the two has again become apparent. In other words, the recent apparent quiescence of the inflation indexes -- headline as well as core -- could well have run its course. It's also notable that these commodity price rallies have continued in the face of somewhat hawkish noises coming from the Fed. Under other circumstances, we might expect to see these prices -- particularly gold -- at least plateau on the prospect of a resumption of the tightening process leading to a restoration of monetary equilibrium. This price behavior suggests the market has become inured to mere words, and substantive action will be required to reduce the inflation premium in sensitive market prices.

As for growth, while all of the Fed speakers last week appeared encouraged by evidence of a quickened pace of expansion, they also made clear that their willingness to tolerate a sustained growth acceleration is limited. "My own assessment is that with growth prospects of the economy improving, there is some risk that we may not see a return to price stability unless monetary conditions are tightened," said Plosser. St. Louis Fed president William Poole suggested he saw growth moving toward a "sustainable" pace of 3%, but added, "If we get a an upside surprise …then monetary policy may have to be tightened somewhat."

It's a good bet, in fact, that the economy is even more robust than it appeared in the initial estimate of 3.5% real growth in last year's fourth quarter. A statistical glitch in accounting for auto production first exaggerated third quarter growth and was more than corrected for in the fourth quarter. The economy also absorbed a moderate inventory correction in the fourth quarter which could well be reversed in the current quarter, as could a modest decline in business fixed investment. Provided that the housing slump doesn't deepen and account for an even larger drag on reported growth (it has taken about 1.2 points off the growth rate in each of the past two quarters), it's an entirely plausible proposition that this economy is now maintaining a growth rate of more than 4% annualized. And that, it seems clear, is well above the upper limit of the Fed's growth tolerance.

BOTTOM LINE: Another spell of wishful thinking took hold of fixed income markets following the FOMC session at last month's end, with interest rate futures fully restoring expectations for at least one rate cut this year and bond yields following suit. The reality remains, however, that the Fed shows absolutely no inclination to satisfy such delusions and appears to be gravitating toward a conception of current conditions that could have it returning to rate hike mode before long. Bernanke's testimony this week will be key in determining the Fed's posture, but we'd look for a more hawkish outlook than the market is currently pricing for. TM