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

MACROCOSM

Retail No Relief for Economic Bears

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David Gitlitz

Bonds have realized that the Fed isn't watching retails sales -- it's watching jobs.

Update to strategic view

FED FUNDS: The Fed's not targeting retail sales, which are not as weak as they may seem anyway. The Fed is targeting "resource utilization" in the labor market. Unless the unemployment rate rises markedly, there's no chance of a Fed rate cut -- and as the economy continues to avoid contagion from the weak housing market, every passing day moves the Fed closer to a rate hike. But while that plays out, the Fed is on hold until further notice.

[see Investment Strategy Dashboard]

Today's soft-looking retail sales data, and yesterday's same-store sales data, might seem to be just what the economic bears and bond bulls were looking for to support their view that a weaker economy will bring the Fed to its senses, and compel initiation of a rate cutting exercise in the not too distant future. But the pessimists were already disappointed by the outcome of the FOMC meeting this week, which showed no tilt toward further dovishness even in the face of the dominant narrative being put out by the mainstream media/economics consortium that the economy is barely keeping its head above water. Indeed, the virtually unchanged post-meeting statement repeated the none too subtle reminder that the "Committee's predominant policy concern remains the risk that inflation will fail to moderate as expected." Thus, a retail sales number that might otherwise have at least sparked a nice knee-jerk fixed-income rally today couldn't overcome the forces of consolidation now at work in the market, with the 10-year Treasury yield actually up 2 basis points on the day at 4.67%, leaving bond prices lower than where they started before yesterday's same-store sales data.

It's also the case, though, that the reported 0.2% decline in April retail sales was heavily influenced by calendar effects (Easter was early in the month, pushing holiday sales into March), and cold weather (last week's jobs report showed that those not working due to weather was the fourth highest for any April in the last 25 years). Following on sizable upward revisions for February and March also contained in today's release, it would be considerable hyperbole to suggest, as the *Wall Street Journal's* news item nevertheless did today, that the retail sales data are "signaling weakness in the economy."

From our perspective, consumption spending is the product of income growth rooted in robust labor markets, which show few signs of slack. Personal income growth is now running at a year-on-year rate of 5.7%, above its average of 5.2% over the past four years -- a period which has corresponded with the unemployment rate falling, on net, from above 6% to 4.5%. With the Fed tying its inflation worries to concern about "high levels of resource utilization" -- Fed-speak for

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

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low unemployment -- policymakers will need to see a significant reversal in the job market in order to come off inflation alert, and we think they're not likely to get it. The latest data show weekly jobless claims -- the best forward-looking indicator of labor market trends -- falling back below 300,000 after briefly spiking above 340,000 last month. By the way, that transient spike corresponded with the survey week for April payrolls, which could explain the "disappointing" total of 88,000 new jobs last month. In any case, jobless claims have averaged less than 318,000 over the past six months, a level consistent with solid continued job growth and a steady to declining unemployment rate.

This sustained labor market tightness will no doubt continue to bemuse our monetary mavens, who are at a loss to explain it in the face of an apparent broad economic softening. In a recent speech, San Francisco Fed president Janet Yellen posited a few alternate explanations. A "benign" one, she said, is that there's a longer than usual lag between slowing growth and the job market response. More "worrisome," she offered, is the possibility that the economy is actually considerably stronger than the data indicate, which could require a policy response to slow growth and subdue inflationary pressures.

It's telling that from the perspective of this policymaker, the "worrisome" possibility is the one pointing to healthy continued growth. But in fact, as we have documented, outside of housing the economy has maintained a vigorous pace of expansion, which is why the labor market has shown little visible sign of strain. If Yellen is opening a window on the considerations now at play internally at the Fed, it's probably a good bet that if the labor market fails to roll over, the Fed eventually will be compelled to resume hiking rates. While we put no credence in the proposition that inflation is a consequence of such real economic factors as job and wage growth, in this case at least there is some end-game congruence with our view that further tightening is required to root out the liquidity excess that remains in place due to the Fed's still-accommodative posture.

BOTTOM LINE: Today's weak retail sales report was dominated by weather and calendar effects and so cannot be viewed as a sign of economic weakness. Fixed income markets since Wednesday's FOMC meeting have also been digesting the Fed's status quo posture and against that saw little upside in the retail release. Without a significant retrenchment in the labor market, "the consumer" is unlikely to be put at risk, and at this point forces remain in place for continued job market strength. However, that is also a growing concern for the Fed, wrongly convinced that sustained labor market tightness is *ipso facto* inflationary. The longer the job market remains robust, the closer the time comes when the Fed will be compelled to resume raising rates.