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TRENDMACRO LIVE!

On Jobs, ISM, GDP Data

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David Gitlitz

The latest wave of data reaffirms our view that the economy is in the process of a reacceleration that bodes very well for a sizeable pickup in reported growth -- and very poorly for any lingering hopes that the Fed might be inclined to cut rates in the foreseeable future. With a yield of 4.95%, the 10-year Treasury note today is at its highest level of the year, and that's with out-month interest rate futures still showing a small chance of a rate cut by mid-2008. We expect yields to continue moving higher as the last of those expectations bleed out of the market and eventually are superseded by recognition that the Fed's next move will be to hike rates, not cut them.

Update to strategic view
FED FUNDS: All data continues to point to reaccelerating growth. The Fed is unlikely to find much comfort in somewhat benign inflation reading, fearing that they will perk up again in response to a resurgence in growth. Bond markets are now priced for virtually no rate cuts, but we continue to expect the next move from the Fed to be a rate hike, and probably within the current year.
[see Investment Strategy Dashboard]

The 157,000 bounce in May payroll jobs coheres with our analysis that the March dip in job growth was a one-time weather effect which, despite a flood of media reports to the contrary, offered scant support for the notion that a softening labor market was at hand. With another healthy 0.3% increase in wages (3.8% year-on-year), an uptick in hours worked, and the unemployment rate remaining at a low 4.5%, the jobs report paints a picture of a tight labor market which both reflects an environment of robust growth and indicates the sustainability of that growth. For one thing, more people working more hours translates directly into higher output.

Another uptick in the ISM manufacturing index, meanwhile, provides additional backing for the proposition that the inventory overhang that was hindering growth in manufacturing has passed and production is ramping higher. At 55, the overall index is now at its highest level since April 2006, while strong gains in new orders and production have seen those components return to their robust levels of early last year. Revisions to the first quarter GDP release also showed inventory liquidation taking 1% out of reported growth, a factor which could well reverse in the current quarter. Otherwise, while the 0.6% growth rate was the slowest in four years, we found that in important respects, the data offered considerable encouragement. The only other major decrement to growth was due to a decline in "net exports," which also subtracted 1%, due largely to a surge in imports. This is unlikely to be repeated, however, and with the pace of global expansion showing no signs of a let up, exports should return to a solid growth path. At the same time, final sales to domestic purchasers -- or, as it's commonly known, "domestic demand" -- was up by 2.5%, best since the first quarter last year. Also, business fixed

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investment was revised up to 2.9% from 2%, and should be a net positive for growth going forward.

BOTTOM LINE: The news is probably not being greeted with unbridled enthusiasm at the Fed. The minutes of the May 9 FOMC meeting released yesterday captured policymakers flummoxed by the continued strength of the job market even in the face of the reported deceleration in overall growth. The Fed's case for remaining on hold in anticipation of a break lower in core inflation is predicated on the idea that the labor market will cooperate by rolling over, and it's reasonable to assume that it wants to see unemployment moving convincingly back toward 5%, and soon, which we view as unlikely. The minutes specifically pointed to current job market conditions as an upside inflation risk factor, while also suggesting that panel members were not persuaded that recent downticks in reported inflation amounted to a trend lower. Today's benign reading on core personal consumption prices -- up 0.1% on the month, and 2% year-on-year, the top end of the Fed's supposed "comfort zone" -- should be seen in this context. Without confirmation from real economic indicators of a slowing in "aggregate demand" -- particularly in employment -- speculation about the Fed returning to rate-hiking mode is a matter of "when," not "if."