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

FED SHADOW

Fed in the Crosshairs

Friday, October 5, 2007

David Gitlitz

The first rule of central banking is: never admit you made a mistake. That means another rate cut at the October FOMC meeting.

Update to strategic view
FED FUNDS: Though it becomes clearer that the 50 bp September rate cut was a mistake, the Fed isn't about to admit it. We still think there's one more 25 bp cut to come at the October FOMC meeting. **US STOCKS:** Today's upside reaction by stocks to strong upward revisions in jobs data suggests that prices are driven more by growth expectations than rate cut expectations. As growth prospects continue to firm, so will stock prices.
[see Investment Strategy Dashboard]

Today's jobs data, particularly the sharp upward revisions to the two previous months, confirms our impression that the report of a slight decline in August payrolls was probably an anomaly, and that the alarm concerning the economy's health prompted by that report was significantly overdone (see "Bad Jobs" September 7, 2007). That data spurred an abrupt intensification of expectations that the Fed would be compelled to initiate a round of rate cuts, which expectations the Fed more than satisfied last month by dropping its overnight rate target by 50 basis points, to 4.75%.

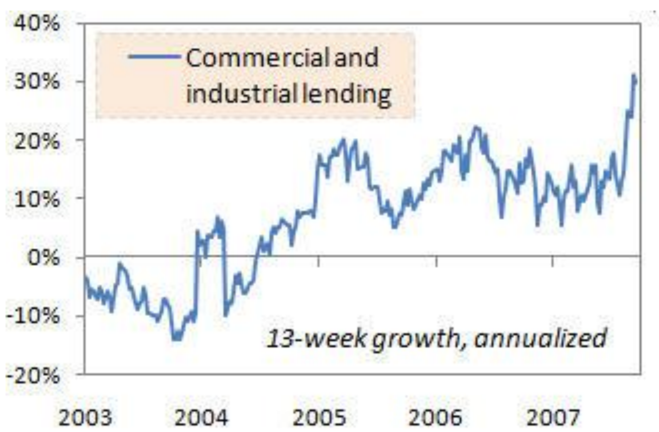
In the wake of today's report showing a gain of 110,000 payroll jobs in September, and an even more impressive addition of 463,000 to the ranks of the employed picked up by the household survey, the key question now is: how the Fed will respond? Will it see the data as indicating that the economy was never really at significant risk, making additional action unnecessary? Or will it continue to seek rationalizations for its stated perceptions of downside economic risk, in which case another rate cut at the end of this month is the most likely outcome. On balance, we'd say circumstances at this point tend to favor the latter option, and that a 25 bp cut on October 31 remains the best bet.

The Fed dressed up its decision on September 18 to cut rates by 50 bp with language about "adverse" economic effects and "uncertainty" arising from the credit market turmoil, but in reality the move was rooted in concern about the blowback that might have resulted if market expectations arising from last month's jobs data had been disappointed. But the Fed cannot publicly acknowledge that it was caving in to the market, so it constructed an economic rationale to justify the decision. That rationale was based on an outlook of significant downside economic risk. To fail to cut rates again would be tantamount to jettisoning that outlook, which would amount to an acknowledgement that the first rate cut was a mistake. The Fed does not, under any circumstances, acknowledge mistakes.

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



The basic elements of the rationalization now at work could be seen in today's speech by vice chairman Donald Kohn to the Philadelphia Chamber of Commerce. "I expect that the financial market turmoil of the past few months will leave an imprint on the cost and availability of credit to many household and business borrowers," Kohn said. "It would not be surprising to see less-generous credit for a wide variety of loans to business and households." He added that "credit availability is likely to be tighter than before, consumer confidence is down, and businesses will probably be a little more cautious for a while, suggesting that these components of aggregate demand could become more subdued in coming months." There was no room in Kohn's formulation for recognition that by some important measures, credit creation remains quite robust. For example, over the past 13 weeks, commercial and industrial lending has posted an annualized growth rate of nearly 35%, a more rapid pace than any seen in more than 30 years.

In taking out insurance against what it paints as downside economic risk, the Fed believes the recently muted backward-looking statistical inflation data provides it with considerable flexibility. But it reserves no place in its models for the forward-looking market price indicators which continue to point to an intensification of inflationary influences attributable to an already accommodative monetary policy moving into an even deeper sub-equilibrium posture. Even with today's labor market data showing up in the futures markets as a significant cut in the odds of a rate cut this month, the price of gold rallied nearly $4 to above $740, and the dollar lost further ground against it major currency counterparts. The message of these indicators is that the purchasing power of the unit of account will not begin to be restored simply by having the Fed fail to get even easier. The Fed is already too easy, and the dollar's real value is likely to continue to erode unless it signals that it is prepared to reverse course and move toward restoration of monetary equilibrium.

BOTTOM LINE: Today's upbeat jobs numbers have taken what had been the near certainty of a rate cut at the October 31 FOMC meeting and reduced it to a toss-up. At the same time, the strong equity market response puts paid to the notion that the stock market recovery has been closely tied to hopes for further rate cutting. Equities reaching new highs as the rate cut probabilities get slashed tells us that this market retains considerable upside as confidence in growth is restored. Unfortunately, these positive indicators are unlikely to make much of a dent in the Fed's institutional perspective any time soon. The central bank has sold itself on its own story about downside economic risk and seems committed to sticking to it, at least through the next FOMC meeting.