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Don't Be Surprised If Data Surprises

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The Fed won't dare disappoint rate cut expectations. But data could change the long-term game.

Update to strategic view
FED FUNDS, US BONDS: The FOMC will surely cut the funds rate by 50 bp at Wednesday's meeting. But by the week's end, a series of upside macro data surprises could sharply lessen today's expectations for further deep cuts, leaving Treasuries across the curve very vulnerable.
[see Investment Strategy Dashboard]

This is going to be an important week for economic data, culminating Friday with the January jobs report and ISM manufacturing index -- and leading up to that, durable goods, fourth quarter GDP and personal income and consumption. All the gloom and doom about the economy being on the cusp of recession, if not already there, could be borne out if these releases show across-the-board weakness. But it's our bet that the data on balance will turn out better than expected, resulting in at least a marginal shift toward a less dire outlook.

Of course there's another event in this busy week that will be the focus of much attention -- the FOMC meeting on Wednesday, which is now expected to yield another 50 bp reduction in the fed funds rate target, to 3%. There might have been an opportunity to moderate that outcome were the employment report due for release prior to the meeting. But with the futures markets locked into the near certain probability of a 50 bp cut, the Fed is highly unlikely to choose this occasion to start disappointing expectations (see "'Act As Expected'" November 28, 2007).

Fed chairman Ben Bernanke and his policymaker cohorts regularly insist that they base policy on forward-looking forecasts, not backward-looking data. But there's no doubt Bernanke was rocked by the December jobs numbers, particularly the reported pop in the unemployment rate to 5% from 4.7%. In his remarks since then, Bernanke has cited the "disappointing" December employment data in enumerating why he sees the labor market as a "consequential risk to growth" (see "Helicopter Ben Takes Flight" January 11, 2008). Last week's emergency 75 bp rate cut was a response to the global market turmoil. But from the Fed's analytical perspective, that turmoil grew out of growing worry about a US economic downturn, and the employment data was a key factor driving those worries.

But the apparent weakness in the December jobs report might well end up standing as nothing more than the inevitable variability in such data. Were the labor market weakening as much as was feared following the December release, it would also be showing up in the weekly reports

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on initial unemployment claims. But claims have declined for four consecutive weeks, and are now running at a four-month low of 301,000. Far from indicating the onset of recession, such a level of claims has historically been consistent with a robust pace of job growth. If Friday's report shows a bounce back to a six-figure rate of payroll growth and a decline to below 5% in the unemployment rate -- which we think is entirely plausible -- all the talk about a looming recession will certainly be quieted considerably.

Of the other data due for release this week, fourth quarter GDP will offer an interesting report card on the recent past, but probably won't have much relevance to the outlook going forward. It’s notable that in the midst of all the negative sentiment which has dominated the past couple months, the consensus on fourth quarter growth has already been lifted from 0% to about 1.5%. We think that's probably still too low, and are looking for a 2 handle on the real growth rate -- that's practically a certainty, if the wild-card of residential investment is removed from the calculation. But even if it's somewhat lower, it would be a mistake to take that as the harbinger of an extended slowdown. Growth in the first quarter last year came in at 0.6%. In the following two quarters it averaged 4.4%.

Our continuing confidence that we are currently experiencing nothing more than a mid-expansion soft spot is primarily due to the highly accommodative stance of monetary policy -- throughout the Fed's aborted rate-hiking cycle, and even more so now. In the past four decades, there has not been a single recession that was not preceded by the real funds rate exceeding 4%. At its highs in the recent cycle, it only got to 3.3%. Currently the real rate -- using the year-on-year change in core PCE inflation as the deflator -- is at 1.3% and headed lower. *Tight money causes recessions*. The Fed is easy, and likely to continue getting easier. That will present difficult challenges in the months to come as the Fed eventually faces the inflationary consequences of its slide back into an excessively easy posture. But for now, it means that what has historically been the chief causal factor explaining economic downturns -- tight monetary policy -- is simply not present.

The fact that the Fed is maintaining such an accommodative policy posture also gives rise to considerable skepticism here that a restraint on credit availability represents a key economic vulnerability at this point -- though the Fed consistently holds that it does. Rates this low don't discourage lending -- they provide a significant boost by giving lenders a highly appealing carry on a broad range of assets. No question, some major institutions have suffered considerably due to their subprime exposure in the credit market crisis. But such isolated balance sheet hits don't usually result in a rupture of the credit creation process. As it stands now, lending continues to show growth at healthy double digit annualized rates. And even the asset-backed commercial paper market -- the sector most devastated by the credit market upheaval -- is showing signs of recovery, with outstandings up almost 9% in the past 4 weeks.

BOTTOM LINE: There's little doubt the Fed will confirm market expectations and cut the funds rate to 3% on Wednesday. But expectations markets at this point are also pointing toward cuts at the following two meetings, bringing the rate to 2.5% by April. Those expectations, as well as fixed income markets priced for continued rate cuts more generally, could face considerably downside risk if new data, particularly Friday's jobs report, provide a more upbeat view of current economic conditions, which we think is likely. At the same time, with gold at new record highs touching $930 today, the dollar weak and the Treasury yield curve continuing to steepen, the current downside vulnerability pales against the longer-run risks that will become apparent when the Fed is faced with no choice but to respond to the inflationary breakout made inevitable by its long-run era of accommodation.