Donald Luskin, Chief Investment Officer
David Gitlitz, Chief Economist

FED SHADOW

The Fever Breaks

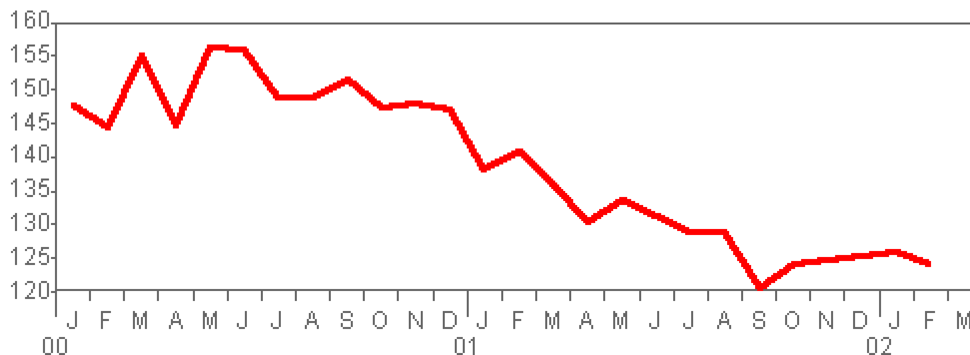
Tuesday, March 26, 2002

David Gitlitz

The ability of the bond markets to make back their early gains today and close on the upside -- after severely breaking down in the moments following the stupendous (at least according to the media echo chamber) consumer confidence data -- may be the best indication yet that the fever of **Fed** rate-hiking expectations is breaking.

A yield curve still priced for as much as 200 basis points in rate hikes by year end, and 250 bps by this time next year -- with not a trace of inflation risk in sight -- appears to offer compelling upside as the market moves to discount for a more plausible expectations environment. Today alone, December Eurodollar futures, although continuing to imply a funds rate of nearly 3.75%, rallied by 10 basis points. Three weeks ago, we established a model curve-flattening position to take advantage of the then-mounting sentiment that the Fed would be compelled to act aggressively to restrain an economy on the cusp of a resurgence (see "Leap Forward, Or Leap of Faith?" March 5, 2002). Today, we are closing out that model position, booking profits of 1.45% based the cost of the long side of this long/short trade as executed in the physical market -- or 23.36%, based on the initial margin requirement if the trade had been executed in futures. We are now reaffirming our bullish view on long-dated issues.

Manufacturers' New Orders: Durable Goods Ex-Transportation
($billions)



The bounce in the ephemeral and vastly overemphasized consumer confidence index could not obscure the ongoing uncertainty about the strength of this recovery, underscored by the earlier release of the durable goods data. After four consecutive monthly gains, February new orders outside the volatile transportation sector fell by 1.3%. Actually, as the accompanying chart illustrates, even that earlier string of increases could hardly be considered to denote "strength" in any real sense. Instead, we observed a quick bounce off the immediate post-9/11 lows, and on net a rather muted rebound since. At this point, new orders ex-transportation remain below their pre-9/11 levels of last August, which already were down some 13% from a year earlier.

http://www.trendmacro.com
don@trendmacro.com
dgitlitz@trendmacro.com

325M Sharon Park Drive #325
Menlo Park CA 94025
Phone 650 429 2112
Fax 650 429 2112

42 Forest Drive
Parsippany NJ 07054
Phone 973 335 5079
Fax 973 335 8016

But in mollifying the market's worst fears about the Fed's inclination to lift rates now and ask questions later, the weaker-than-expected durable goods data received crucial backing from the remarks of **Dallas Fed President Robert McTeer**. A voting member of **the FOMC** this year, McTeer told a conference in Prague that in the context of low reported inflation and a still-strong dollar, there need be no rush to reverse last year's rate cuts. "I am fairly hopeful that inflation can continue to decline somewhat in the next few months," he said. "Sooner or later, as the economy gathers momentum, and gets stronger, an adjustment will have to be made. But I am not in a hurry." The Fed, he added, "has been appropriately accommodative...On the other hand, the dollar has been strong in foreign exchange markets, indicating policy has not been terribly exuberant."

Well, better late than never. In those few sentences, McTeer went a good deal further than any other member of the central bank has yet gone in making sense of the present monetary environment. As opposed to the myth now at large that the Fed's current stance is "extraordinarily easy," the dollar's real value in terms of foreign exchange and commodities remains 15-20% stronger than it was 3-4 years ago. With gold now in a range around $295, up from around $275 during most of the last two years, the most that can be said is that deflationary pressures have abated to some extent. And, yes, at some point it will be appropriate for the Fed to move rates somewhat higher. When economy-wide expected returns approach long-term trend rates around 3-3.5%, the current 1.75% funds rate will be rendered excessively accommodative, which will be indicated by behavior of sensitive market prices. At present, there are no such indications, which at least Bob McTeer seems to understand. TM