TrendMacrolytics

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

MACROCOSM

Short Rates Take the Long View

Friday, August 1, 2003
David Gitlitz

Today's data was a mixed bag, but short rates continue to forecast resurgent growth.

This morning's mixed bag of economic data allowed long-maturity Treasuries to make back the bulk of their early point-and-a-half losses and gave equities an excuse to continue pawing ground in ranges that have prevailed since June. The news, however, was still too much to bear for short-dated issues that have been forced to play catch-up with the reality of an economy showing clear signs of finally shaking off the doldrums and putting **the Fed** "in play" to enter a rate-hiking cycle much sooner than was anticipated just a few weeks ago. The two-year note, which has been lagging behind the carnage at the longer end of the curve, has picked up about 15 basis points in yield just since Tuesday. At a yield around 1.85%, it is now posting the largest spread relative to the current fed funds rate in more than a year.

That can be seen as a reflection of the sea-change in Fed expectations that has been registered in the interest-rate futures pits, where three-month Eurodollar futures are now priced for between 75 and 100 bps in rate hikes by next June. On July 11, we established a **Model Position short June '04 Eurodollars**, suggesting that by discounting for just one 25 bp hike, the contract appeared to present considerable downside vulnerability given the brightening economic outlook (see "Betting on Growth" July 11, 2003). Since then, the implied yield on the contract has risen by more than 60 basis points, to 2%, for a gain of some 200% on the short position.

As for the data, we see nothing to dissuade us from the proposition that the economy remains poised for significant acceleration. In the world of media and politics, of course, there is no match for the drama of the monthly jobs report, which today showed a loss of another 44,000 jobs last month (34,000 from private sector payrolls). In the real world, however, it's understood that before employment can start growing again, employers must be persuaded that the return on the marginal worker will at least equal the marginal cost. And before that can happen, we would expect to see persuasive evidence of improved prospects for sustainable gains in production, revenue and profit. In that regard, today's other major piece of data, the **ISM** manufacturing survey, showing the first reading in five months above the benchmark 50 level for the overall purchasing managers' index, offered additional encouragement that the worst-hit sectors of the economy are on the mend. Probably even more impressive, though, was the jump of 4.4 points in the forward-looking new orders index to 56.6, which was both its third consecutive monthly increase and the third month above 50. Added to the signs of recovery in business fixed investment seen in yesterday's report on second quarter GDP, including a 16% annualized gain in info-tech investment, and it's clear that the economy's long-dormant engines of capital formation are again starting to purr. TM

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

Offices:
Menlo Park CA
Parsippany NJ
Stamford CT

Phone:
650 429 2112
973 335 5079
203 322 1924