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

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Calm Before the Storm

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David Gitlitz

Fixed income markets are taking false comfort from the Fed's boilerplate.

After a number of quarters of vigorous expansion accompanied by less than stellar job growth, it should be clear that the trust conventional wisdom invests in the payroll data as the supreme economic indicator is badly misplaced in this cycle. It could be, in fact, that the more important data point in the monthly employment report is now the unemployment rate rather than payrolls. At 5.2% -- down from 6.3% in mid-2003 -- the jobless rate is back to levels that were bettered only during the height of the late-90's boom, when unrealistic expectations of sustained out-sized returns affected work force expansion as much as it did investment decisions. There are indications suggesting that for all practical purposes, the economy is nearing what could be considered "full employment."

Old habits die hard, however, and the credit markets are off to the races on what we see as badly misplaced hope that today's jobs report will incline **the Fed** to alter course. The reported payroll gain of 146,000 for January is entirely in line with average rates of job growth since the labor market recovery began 18 months ago. In four of the seven months since the Fed began this rate-hiking exercise last June, monthly payroll growth was below today's number. In the midst of abundant indications that the forces of sustainable expansion are firmly entrenched, today's data isn't likely to make much -- if any -- difference in the Fed's trek toward policy neutrality. Today's speech by **Alan Greenspan** in **London**, noting the potential for higher import-price pass-through owing to a weaker dollar, suggests that if anything the Fed chief is now more attuned to the inflationary implications of the currency, and at the least seems unlikely to court further dollar weakness at this point.

Previously, we detailed how subtle shifts in the Fed's open-market operating stance, combined with a bolstering of expectations that the policy normalization process would not be called to a premature halt, contributed to the dollar's rally off its lows late last year (see "A Dollar Rally?" January 4, 2005). On first blush, the Fed's move Wednesday appeared to run counter to that, and seemed the epitome of the steady-as-she-goes, cautious gradualism that has largely characterized the Greenspan era. The statement accompanying the wholly anticipated announcement lifting the funds rate another 25 basis points to 2.5% was identical to that issued following the previous meeting in December. The formulaic boilerplate language gave no hint that the central bank has any more urgency about facing the task at hand than it did when the process began last June. The familiar assurance that rates would continue to rise "at a pace that is likely to be measured" remained in place.

And yet, participants in the market for dollar liquidity have taken some comfort in the Fed's words, pushing the dollar above $1.30 against the euro, and pinning gold below $415 for the first time since last September. Why? Most important, we think, is the central bank's acknowledgement that the "stance of policy remains accommodative." This strongly suggests that an end to the process -- even after moving up its overnight rate target by 150 basis points --

is not in sight. Indeed, at this point we continue to have little reason to think the schedule of at least a 25 bp hike per meeting will be interrupted before the end of this year. That would put the year-end funds rate no lower than 4.25%, and we don't rule out the possibility of at least one 50 bp move coming into play.

From our perspective, the credit markets are badly mispriced for this eventuality. While the curve-flattening trade continues to garner headlines, it's usually overlooked that the short end is now anchored to an expectation of a 3.25% to 3.5% funds rate. If those expectations turn out to miss by at least 100 basis points, as we believe they will, it's not likely the longer end of the curve will escape unscathed. With the 10-2 curve currently at 80 basis points, for the 10-year note to remain in current ranges would require that the curve move toward inversion. Given that the inflation expectations environment still is likely to get considerably worse before it gets better, we view that as highly unlikely.

Bottom Line: Today's marginally sluggish employment report is not out of line with recent experience in a healthy expansion, and is unlikely to move the Fed toward a less forceful posture. The Fed, in fact, is signaling that it remains on a rate-hiking course that is being significantly underestimated in the market. The yield curve looks to be vulnerable to considerable upheaval as it corrects the current mispricing.