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No Restrictions

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It's good that there's nothing restrictive about a 5% funds rate -- because the Fed is going even higher.

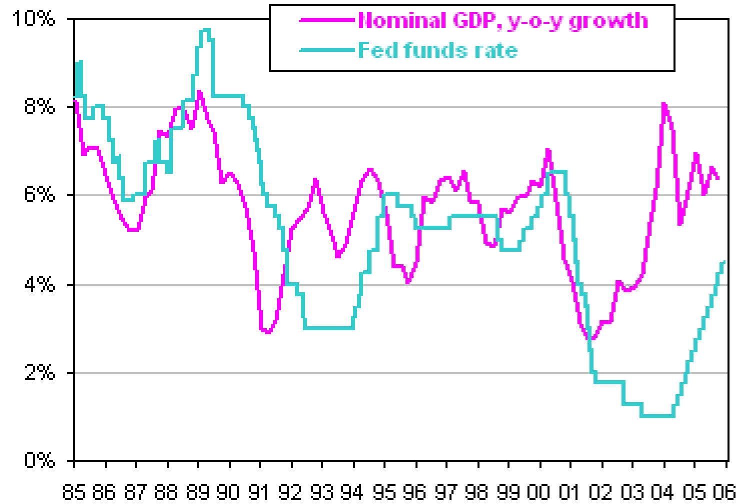
The chances of **the Fed** sanctioning at least two more **rate hikes** are inexorably moving toward the status of "sure thing." **Sentiment** is growing that at that point, with the **fed funds rate target** at 5%, **policy** will have moved beyond **"neutral"** and will reach the realm of **"restrictive."** A clear manifestation of that viewpoint can be seen in **the inversion of the yield curve**, which essentially represents a bet that not long after the Fed raises rates to 5% by mid year, the economic braking effect will compel it to **cut rates**. This is consistent with the **Eurodollar futures curve**, which is showing significant chances of a rate cut by early 2007.

We believe, however, that the supposition that monetary policy will be in an objectively **"tight"** posture with a 5% funds rate is unfounded. In fact our analysis suggests that at that point, the Fed will continue to be on the **accommodative** side of the policy continuum, and that further action will be required to reach **equilibrium**.

Assessing the stance of policy cannot be done in a vacuum. Whether any given target rate at any given time can be considered easy, tight, or neutral depends on **contemporaneous conditions** with regard to current **inflation** and **inflation expectations**, **opportunity costs**, and **expected returns**. During the 2001-02 **recession**, for example, the Fed cut rates from 6.5% to below 3% before any evidence of an easier liquidity posture began to surface. In that environment, with inflation expectations transmuting into deflation expectations and expected returns collapsing, even a 3% funds rate was excessively tight. In the current economic context, by contrast, 4.5% clearly remains an accommodative rate.

One useful, although hardly perfect, measure of the relative ease or tightness of policy is the **real**, or **inflation-adjusted**, rate. The official inflation indexes are among the most backward-looking, deeply **lagging** data series in the statistical universe, and it's certainly true that the appropriateness of policy must be evaluated against the changing expectations of future inflation as well. However, the real rate over time has provided some useful benchmarks. Relative to **core CPI**, for example, the current 4.5% funds rate amounts to a real rate of about 2.4%, which is at the low end of historic norms. Assuming that current inflation remains relatively stable, another 50 basis points in rate hikes will lift the real rate to a level which, while somewhat less accommodative, has not historically been "restrictive." From 1995 to 98, for example, the real funds rate averaged about 3%, which accompanied real GDP growth averaging some 3.7%. Significant economic slowing has historically been seen when the Fed puts the real funds rate at a level approaching 4%.

We have found that the relationship between **nominal GDP growth** and the funds rate offers even richer analytical opportunities for assessing the stance of policy (see the chart on the following page). Nominal GDP can be seen as proxy for economy-wide **available returns**. As can be seen, over the past 20 years there has been a notable correlation between the two, and when the Fed gets the funds rate to levels approaching or exceeding nominal GDP, the consequences invariably are damaging to growth. On the other hand, if the Fed keeps the overnight rate at a level representing a significant discount to available returns, the opportunity cost of holding **money** becomes prohibitive. That reduces **demand** for money, which is the fundamental factor in any **currency-cheapening** episode inevitably leading to higher inflation.



It's noteworthy that as the Fed entered its **hyper-accommodative easing mode** in mid-2003, cutting the funds rate to 1% as nominal GDP accelerated, **market price indicators** including **gold**, **commodities** and the **dollar's foreign exchange value** all nearly simultaneously broke out of previous ranges to signal that a significant dollar-weakening event was at hand. None of those indicators has moved consistently back toward its earlier levels, as would be expected if the Fed were seen reaching monetary equilibrium. The price of gold is now some 60% above the levels around $350 seen before the Fed adopted its **ultra-easy** stance. It's doubtful that another 50 basis points will get them to equilibrium, especially considering that nominal GDP is likely to rise further in the next couple quarters.

However, the dawning reality that the Fed may well keep rates higher longer than has been anticipated up to now appears to be a significant factor in today's **bond market sell-off**. The half-point decline in the **10-year Treasury**, lifting the **yield** to 4.65%, has been characterized by a significant **curve flattening**, with the 2/10 inversion reduced from 11 to eight basis points. Since the inversion peaked late last week at about 16 basis points, in fact, trading has often been marked by supposedly **"technical" factors**, explained as **profit taking** to lock in gains made on the inversion trade. However, if the market is now calling in its bets on the extent of the inversion, it also suggests a growing level of doubt about whether the expected circumstances that gave rise to the inversion in the first place, with the Fed likely to begin cutting rates within the foreseeable future, are likely to pan out.

Bottom line: The supposition that a 5% funds rate will represent a "restrictive" policy stance has been key to the rationale supporting the yield curve inversion, but we find that it fails to withstand analytical scrutiny. A nominal 5% rate will amount to a real rate that has been consistent with vigorous growth, and will continue to represent a discount relative to nominal GDP growth that will leave the Fed in an accommodative posture. As such, our bet is that the Fed will find itself compelled to move beyond that level to restore monetary equilibrium. Although we arrive at that conclusion using a market-price framework that fundamentally differs from the Fed's **demand-based output gap model**, it's likely that the macro indicators guiding the central bank will keep it in **rate-normalization mode** in order to prevent the economy from **"overheating."** At some point, however, there is a real risk that the Fed will move from doing the right thing for the wrong reasons to doing the wrong thing for the wrong reasons -- if they continue to raise rates in order to slow growth even after market prices indicate that equilibrium has been reached. TM