TrendMacrolytics

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Another Reality Check

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The market has reversed last week's false hopes, but it's still underestimating the extent of Fed action.

Credit markets are weathering the latest in a long-running series of reality checks, as the last two days' worth of **stronger than anticipated data** has rendered all but inoperative last week's hopes that **the end** was near for **the Fed's rate-hiking exercise**. As we noted last week, the Fed remains highly dependent on incoming data to shape its **policy outlook** (see "Sorry -- Still Not Done Yet" April 20, 2006). Any belief that the end is in sight depends on clear confirmation that the **pace of expansion** is **slowing to the "trend" rate** around 3% that the Fed's internal forecasts are now projecting. Our analysis, however, is that such a marked **growth** decline is unlikely, which will keep the Fed lifting rates beyond levels currently expected.

Those clinging to a slower-growth perspective had to be shaken by the latest data. In addition to fostering additional doubt about the **housing market** functioning as a widely expected source of significant slowing, today's data also showed that **expected returns** continue to support a robust environment for **capital formation**. With today's reported 3% jump in **new orders for core capital goods**, this critical indicator of capital investment activity is showing year-on-year growth of nearly 12%. As a result, **interest rate futures** have completely reversed the gains seen last week on release of the March **FOMC minutes**, which were interpreted as presaging the near-term end of **Fed tightening**. July **fed funds futures** today are back to pricing for a near two-thirds chance of a 5.25% rate emerging from the late June policy session. The renewed **ramping of Fed expectations** has been reflected across the **yield curve**, with the **10-year Treasury yield** today posting a new four-year high of 5.10%.

Fed chairman Ben Bernanke will step into this setting of economic ferment tomorrow when he testifies on the economic outlook at a hearing of the **Joint Economic Committee**. Our expectation is that Bernanke, while attempting to avoid tipping his hand one way or another, will offer largely upbeat testimony. He may, though, point to **high oil prices** as a factor that could slow growth somewhat in the months ahead, and that could, in turn, provide some support for those who want to believe the Fed's task is nearly complete.

But just as the near-tripling of **crude** prices over the last three years has had a negligible impact on the economic climate, we have no reason to think the latest bump higher is likely to have any greater effect. From our perspective, it's no coincidence that oil prices began accelerating about three years ago, along with **gold** and other sensitive **commodities**. That's when the Fed went into the **hyper-easy phase** of its **rate-cutting cycle**, fostering an **excess liquidity environment** that it has yet to correct. If the Fed were not still in an **accommodative posture**, the higher costs of energy would be forcing **reductions in other spending**. There's no indication, however, that that's happening. Once the Fed brings policy back to **equilibrium**, higher energy prices would likely have the deleterious economic effects that have been avoided so far. Once the Fed gets policy to equilibrium, however, oil prices are likely to roll over along with the complex of commodities that have been boosted by the easy money posture of the central bank.

BOTTOM LINE: The latest economic data is spurring another recalibration of Fed expectations, as the continued strength of the expansion delays the anticipated end of this policy cycle. At this point, the market continues to expect the funds rate to top out at 5.25%, likely by this summer. Our view, however, is that the Fed will have to do more to reach policy equilibrium and, in its current mode of doing the right thing for the wrong reasons, the Fed is likely is to reach the same conclusion: growth continuing to exceed sustainable "trend" levels will be unacceptable to our monetary mavens. Although the benchmark 10-year Treasury yield has reached new four-year highs of 5.10%, we see further significant downside risk at the long end of the curve, consistent with our sense that market expectations are still undershooting the likely extent of Fed rate action. We continue to look for this cycle ending with a funds rate target no lower than 5.5%, and do not rule out 6% as the stop point of this policy episode. TM