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Data Dependent

Thursday, July 27, 2006

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Tomorrow's GDP report isn't likely to give Bernanke the excuse to stop the rate hikes.

Less than two weeks away from the August 8 FOMC meeting, hope that the Fed is poised for at least a pause in the rate-hiking process has captured market sentiment. With Fed chair Ben Bernanke relying on a slowing economy to give him the latitude to retreat to the sidelines, every twist and twiddle of economic news is being enlisted to support the case for an end to the tightening cycle. In this environment, tomorrow's release of the advance estimate of second quarter GDP growth -- normally merely a backward-looking statistical curiosum -- will be critical to the near-term policy outlook, as well as the market's pricing of that outlook.

The extent to which the market is primed to seize on any hints of slowing to buttress the "Fed is done" storyline could be seen in the response to yesterday's release of the Fed's beige book. As headlines circulated touting the theme that the "Fed sees some slowing," interest rate futures rallied, with the August fed funds contract lowering the odds on a rate hike from better than even money to about 43%. While media accounts highlighted the signs of cooling growth reported by the Fed, the document actually provides a rather ambivalent summary of current economic conditions. After acknowledging the "numerous individual reports pointing to evidence that the pace of growth has slowed," the report goes on to specify that retail sales were running only "slightly weaker" than earlier in the year, and "reports from the manufacturing sector were strong, with significant gains in output and sales, especially for durable goods." At the same time, while the beige book says price increases "remained modest on net," it also notes that "upward pressure from the elevated prices of energy and other inputs persisted."

Update to strategic view

US MACRO: The Fed's forecast of 2% to 2.5% real GDP growth for the rest of 2006 is too conservative. The supply side of the economy remains strong, so we expect growth in the 3.5% range.
FED FUNDS: The economy is not slowing enough to give the Fed the excuse to prematurely halt this rate-hiking cycle. We stand by our call for a hike in the funds rate to 5.5% at the August 8 FOMC meeting.
US STOCKS: A stronger than expected GDP report, with a higher than expected deflator, would probably mean a set-back for stocks. But if it keeps the Fed from prematurely ending this hiking cycle, it will have been a blessing in disguise -- and an important buying opportunity.

[see Investment Strategy Dashboard]

To considerable degree, in pricing an asymmetric bias toward an end to the rate hikes, the market is taking its cue from Bernanke himself. He has clearly laid out a scenario of slowing growth leading to easing inflation pressures that would put the Fed on hold pending further developments. But the first link in Bernanke's specious chain of causality is a sharp slowing in growth, and we don't think he's going to get it. No, we won't see a repeat of the first quarter's blistering 5.6% grow pace, which in important respects reflected a catch-up for the artificially depressed sub-2% growth rate reported in the fourth quarter of last year. But by all the indicators we monitor to gauge the entrepreneurial risk-taking impulses which are the foundation of growth, the supply side of this economy remains strong. Ready availability of capital as seen in tight credit spreads, double-digit commercial and industrial lending growth, and increasing

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venture capital disbursements are not the stuff of economic slowdowns. As opposed to the Fed's implied forecast of 2% to 2.5% growth over the rest of the year, we see no reason to expect a marked slowing from recent trend rates around 3.5%.

The second link in Bernanke's scenario -- a lessening of inflation pressures -- is even less likely to materialize without further action to boost the overnight policy rate. Tomorrow's GDP report will also shed further light on current price pressures. As it is, the core GDP price deflator has been running at annual rates above 3% for the past two quarters.

BOTTOM LINE: Ben Bernanke may not fully appreciate it at this point, but the best thing that could happen in terms of establishing his credibility at this stage of his tenure would be for growth to remain stronger than he would prefer, and thereby preclude a premature end to this policy cycle. It probably made little impression on the output gap modelers at the Fed, but the risks surrounding the current policy environment could clearly be seen with release of the Fed's beige book. With the report widely interpreted as pointing to a slowing economy, cutting the odds of Fed action on August 8, gold rallied back above $630 once again and the dollar fell. Even if growth slows somewhat, it won't keep the inflation embedded by the Fed's long stretch of excessive monetary ease from continuing to feed through the system. What gold and the dollar are showing, however, is that the policy rate remains below equilibrium, requiring further action to keep a moderate inflation uptick from blossoming into a destructive inflation breakout. TM