TrendMacrolytics

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Depending on Undependable Data

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Today's GDP report may take away the Fed's "wrong reason" to do the "right thing."

This morning's GDP report adds significant risk to our upbeat view on the macroeconomy and equities, a view we have taken consistently since early 2003. That risk has little to do with the reported numbers, and everything to do with the mistakes the Fed could make in reaction to those numbers. We are not in the least troubled by the lower than expected real growth reported for the second quarter (2.5%, down from 5.6% in the first quarter). That number is anomalously low in relation to a variety of reliable datapoints, and is highly likely to be revised higher -- and there's nothing in this morning's report, or elsewhere, that suggests on a forward-looking basis that the expansion has reversed its vigorous growth trend. And we are not in the least surprised by the surge in core PCE inflation reported for the second quarter (2.9%, up from 2.1% in the first quarter). This merely affirms, retrospectively, what has been forecasted for three years now by market-based price indicators such as gold, commodities, and foreign exchange.

What worries us is that this morning's report could be the excuse for the Fed to prematurely pause the current rate-hiking cycle (see "Data Dependent" July 27, 2006). We still think that the funds rate will be hiked to 5.5% at the August FOMC meeting, but the risk to that forecast is now quite considerable, and we feel less confident about it than we have in two years of faultless Fed predictions. The fed funds futures market is now priced for less than a one third probability of an August hike. The Eurodollar futures are now forecasting a 25 basis point rate *cut* by September 2007. But if the funds futures are right, then the Eurodollar futures must be wrong. Because a pause now, while gold and the other forward-looking inflation indicators are still at elevated levels, will necessitate higher interest rates later, when the evidence of rising inflation becomes unmistakable and the Fed is forced to act. If the pause is long enough, those future rates will have to be high enough to do serious damage to the economy. We haven't yet crossed the line beyond which that bearish scenario is inevitable. But we're perilously close.

BOTTOM LINE: This morning equities are celebrating the prospect of a Fed pause. We're delighted to see some fulfillment of our prediction that the May decline was a buying opportunity (see Investment Strategy Dashboard: US Stocks). But we are getting increasingly uncomfortable that stocks are too casually ignoring the risks of the pause they are celebrating. We've been confident that the Fed would "do the right thing for the wrong reason" -- that is,

Update to strategic view

US MACRO: This morning's GDP report is inconsistent with overwhelming evidence of continued strong growth, and we fully expect upward revisions.

FED FUNDS: Slowing growth in this morning's GDP report adds considerable risk to our forecast of a hike to 5.5% at the August 8 FOMC meeting. But evidence in the report of mounting inflation will still likely keep the Fed on track for that hike.

US STOCKS: We still think the May decline was a buying opportunity, but a sustainable up-move in stocks will require removal of the risk that the Fed will pause prematurely -- which would lead to much higher rates in the future.

[see Investment Strategy Dashboard]

unmistakable evidence of strong economic growth would impel the Fed to keep raising rates to equilibrium levels, thus fighting inflation as an accidental byproduct of its macroeconomic fine-tuning process. But this morning's GDP report -- which we believe is false evidence of economic weakness -- may have taken away the Fed's "wrong reason." There are plenty of "right reasons" that may still carry the day. For instance, we expect the Fed won't easily ignore the sharp rise in core PCE inflation reported this morning. And no matter what happens, stocks have some significant downside protection in the historic risk premium that has persisted ever since the Fed first embarked on its present inflationary course in late 2002 (see "Inflection Point Deflected" July 11, 2006). But make no mistake about the risks. Gold at $630 implies a future core CPI of 6.1% -- and that implies a Fed that is very, very unfriendly to equities. Despite this morning's rally, we won't have a real "all clear" until gold and the other sensitive market-based inflation indicators head substantially lower. TM