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

MACROCOSM

Denial

Tuesday, September 5, 2006

David Gitlitz

Bond bulls are in the money -- but it's based on dreams, and reality is on the way.

A deluge of data last week rolled off a fixed income market hell bent on pricing for perfection. But the implied growth, inflation and policy forecast supporting bond yields at these levels strike us as increasingly far fetched. Friday's report of an on-consensus gain of 128,000 payroll jobs couldn't shake a market captivated by its own conviction that the Fed is now a one-way bet, with futures moving to price for a first rate cut by January, and fully discounting 50 basis points in cuts by late next year. But at a yield around 4.75%, the benchmark 10-year Treasury presents a compelling asymmetric opportunity, with whatever limited upside remains dwarfed by the potential for a sharp reversal once the market awakens to the reality that the Fed is far more likely than not to resume tightening before entertaining even the possibility of entering rate cut mode. There's probably not much at this point that can keep the central bank from sanctioning a hold on rates for its second straight meeting on September 20, but we see a better than even chance that the case for sustaining the pause will become untenable by the time of the following meeting scheduled for late October.

The market's determination to see only what it wants to see was clearest in its response to the minutes of the August 8 FOMC meeting. From our perspective, the minutes seemed tailored to convey a more hawkish tone after the statement released following the August 8 meeting had been noted for its dovishness (see "Surprise on the Doveside" August 9, 2006). The post-meeting statement acknowledged that "some inflation risks remain," but this came only after the panel surmised that "inflation pressures seem likely to moderate" due to "contained inflation expectations and the cumulative effects of monetary policy actions and other factors restraining aggregate demand." By contrast, the minutes, while repeating the rationale for a decline in price pressures, declared that "appreciable upside risks remained." During the policy discussion "many members thought that the decision to keep policy unchanged at this meeting was a close call and noted that additional firming could well be needed." The policy record went on to observe that a "pause was viewed as appropriate to limit the risks of tightening too much," but also suggested that "members generally saw limited risk in deferring further policy tightening that might prove necessary." In summing up, the minutes characterized the view of policymakers that "inflation risks remained dominant and that consequently keeping policy unchanged at this meeting did not necessarily mark the end of the tightening cycle."

Update to strategic view

FED FUNDS: The Fed seems hopelessly on pause for the September FOMC meeting, but mounting evidence of reaccelerating growth should force a resumption of rate hikes at the October meeting.
US BONDS: Treasury yields are denying the increasingly clear reality of reaccelerating growth. Currently priced for a perfection of slowing growth and an easing Fed, all the opportunity is on the short side -- awaiting the day when the reality of reaccelerating growth and higher rates can't be denied.
US MACRO: Evidence is beginning to confirm our forecast for real growth in the third and fourth quarters at about 3.5%.

[see Investment Strategy Dashboard]

http://www.trendmacro.com
don@trendmacro.com
dgitlitz@trendmacro.com
tdemas@trendmacro.com

Offices:
Menlo Park CA
Parsippany NJ
Charlotte NC

Phone:
650 429 2112
973 335 5079
704 544 6900

While that would hardly seem to represent an "all clear" signal, a bond market in denial chose to ignore this cautionary language, focusing instead on a reference in the minutes to a staff forecast which indicated that "real GDP growth would slow in the second half of 2006 and 2007, and to a lower rate than had been anticipated in the prior forecast." According to this forecast: "The slowdown in the housing market, the effects of higher energy prices on household purchasing power, the waning impetus of household wealth effects on consumer spending, and the effects of past policy tightening were expected to hold economic growth below potential over the next six quarters." And while recent inflation data "had not been encouraging," with growth moderating, energy prices "possibly leveling out" and "contained" inflation expectations, "core PCE inflation likely would decline gradually from its recent elevated level."

With anticipation of a significant economic slowdown key to the Fed remaining on hold, and to the market's hopes that rate cuts will be on tap sooner rather than later, one might think that confirmation of a weakening growth trend would be needed to sustain the exuberance of fixed income investors. Apparently not. Prospects for the Fed retreating to the sidelines were given a considerable boost in late July with the release of an unexpectedly soft initial estimate of second quarter real GDP growth at 2.5% (see "Depending on Undependable Data" July 28, 2006). But when the first update to that estimate last week upped the growth rate to 2.9% -- giving little sustenance to the case for the economy entering a below-trend expansion phase -- credit markets still rallied, purportedly on relief that the revision did not come in above 3%.

The cooling housing market has been a linchpin for hopes of a broad economic deceleration. But the latest GDP data offers no support for that notion. On the contrary, while residential investment accounted for a -0.63% drag on the growth rate, this was nearly entirely offset by a 0.6% boost to growth from *non*residential structural investment. As we have often argued, the residential real estate boom of the last several years could be considered a distortion of market forces resulting from the ultra-low interest rate maintained by the Fed. With rates moving back toward normal, the market's capital allocation function appears to be redressing that imbalance. Commercial and industrial lending is now growing at a year-on-year rate of more than 15% -- the highest in more than 20 years -- up from less than 10% in the first quarter last year.

While that would seem to run counter to the bond bulls hopes for confirmation of their bearish economic views, thus far third quarter data are not giving them much comfort either. Personal consumption expenditures in July rose 0.8%, on par with their levels in January which fed into the first quarter's booming 5.6% GDP growth rate. On a three-month annualized basis, PCE is up at a rate of nearly 8%, the best since the third quarter last year. In other words, the long-awaited death of "the consumer" is nowhere in sight. Rather than slowing, the economy appears to be reaccelerating in the current quarter, with the data available to this point indicating growth in a range of about 3.5%.

It's unlikely that a turn toward a faster pace of expansion will be viewed as tolerable by the Fed. The bond market also chose to ignore a passage in the FOMC minutes which indicated that the Fed's estimate of "growth potential" has been reduced. In revisions to the past three years' GDP data included in the initial second quarter release, the growth rate between 2003 and 2005 was marked down from 3.5% to 3.2%. Under the Fed's fundamentally flawed output gap model, the fact that this slower pace of growth corresponded with an inflation uptick indicates that the pace at which the economy can grow without incurring higher inflation is lower than previously estimated. "Going forward," the minutes said, "output was expected to advance at a pace at or slightly below the economy's potential rate of growth, but several participants noted that the annual revision to the national income and product accounts suggested this growth rate likely was lower than previously believed." While this reflects a basic misconception of the forces actually at work -- consistent with the Fed's erroneous belief that inflation is a function of real constraints on resource availability rather than a monetary phenomenon -- it suggests that any acceleration of growth at this point will likely be met with higher rates. But in the final analysis , the Fed likely will be forced to continue pushing rates up not primarily because of too-robust growth, but because it has stayed to far behind the inflation curve for too long. The acceleration of core inflation from its levels around 1% in late 2003 to more than 2.5% currently has been attributable not to the growth witnessed over this period but to the surplus liquidity provided by the Fed, and first seen in market indicators such as gold, the dollar and commodity prices for months preceding the turn higher in statistical inflation. And the fact remains that the Fed has not yet taken sufficient action to arrest this decline in dollar purchasing power, which ultimately will require rates to go considerably higher than the markets -- or likely the Fed itself -- can currently conceive.

BOTTOM LINE: It would be tempting to think that Treasuries might be catching a whiff of reality today, as the first down day in more than a week coincides with a near $15 rally in the price of gold back to near $640. That may be wishful thinking from longstanding bond bears, and the market's moderate decline today may reflect nothing more than technical position shifting and profit taking following the rally of the past several sessions. But our conviction is stronger than ever that significant further upside for bonds would require further irrationality from a market already deeply in denial. Whether or not today's decline marks a shift in trend, we have no doubt that the real opportunity in bonds is on the short side -- an opportunity that will crystallize when the evidence of reaccelerating growth and continuing inflation pressures become utterly unmistakable, and when there can be no further denial that the Fed's next rate move will be higher, not lower. Indeed, the renewed rally in gold, coming after a drop to a closing low of $612 a week ago, provides an indication that the Fed's tightening mission remains incomplete. Gold may be off its May highs above $700, but taking much comfort now with gold at $640 would be like telling yourself its okay to drive 64 mph in a 35 mph zone, simply because you slowed from above 70. The longer gold and other market-price inflation indicators remain elevated, the more likely it becomes that the Fed eventually will be forced into a posture of monetary stringency which will inevitably be brutal for bonds, and very probably for the economy as well. TM