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MACROCOSM

We Won't Get Fooled Again?

Monday, November 6, 2006

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The Fed admits its mistake about deflation in 2003 -- now it's the same mistake, but about inflation.

In the past five weeks, bond yields have twice been driven to levels pricing for as much as 75 basis points in Fed rate cuts, only to be whipsawed by events raising sharp doubts that such a forecast comports either with economic or policy reality. The latest such occasion was Friday's jobs report, which hammered the 10-year Treasury by near a full point, driving a 12 basis point reversal in the yield, to 4.72%. Given this market's well-documented penchant for wishful thinking, we can hardly rule out the possibility of another excursion to fantasyland. Even after Friday's "correction," futures remain priced for the funds rate next year declining by nearly 50 basis from the current 5.25% target. But this continues to define what we see as only the first level of vulnerability for bonds, clinging to a slowdown scenario that appears increasingly unsupportable by ground-level conditions.

Update to strategic view
BONDS: After last week's "correction" following a surprising jobs report, bonds could lapse back into complacency about the Fed in the near term. But in the intermediate term, continuing evidence of stronger than expected growth and inflation will cause the bond market to abandon its hopes for Fed ease, and prices will surely fall commensurably.
[see Investment Strategy Dashboard]

Certainly an unemployment rate dropping to a 5-year low of 4.4%, with hourly wages advancing at a 4% annual rate, offers no such support. Perhaps the most compelling aspect of the new employment report was its upward revisions to the previous two months' payrolls. September was revised higher by 97,000 jobs, nearly tripling the initially reported gain of 51,000. August payrolls, meanwhile, were revised up sharply for the second time, and now show total growth of 230,000 jobs for the month, versus the first estimate of 128,000. Several implications arise from this. For one, it suggests that the Bureau of Labor Statistics' re-estimate of payroll growth in the 12 months ended March in its annual benchmark revision was no fluke. BLS last month estimated that 810,000 more jobs were added in that twelve months than had been reported, an average of more than 67,000 per month. The revisions for the past two months averaged slightly more than that, indicating that the underestimate of job growth in the establishment survey continues. That the market gave significantly less weight to the report of a below-expectations gain of 92,000 in October payrolls suggest that the reliability of the first crack estimate in the establishment data is being seriously questioned. These events further support our contention that the often maligned household survey, which recorded an addition of 437,000 jobs last month, is actually a better barometer of this dynamic entrepreneur-driven labor market.

The October jobs data knocked the wind out of the hard landing enthusiasts who were relishing the weak-looking third quarter GDP figures and the apparent softening seen in the latest ISM manufacturing survey. A closer looker at both, however, reveals an underlying rate of expansion consistent with better than 3% annualized growth. The hard landing story also took a serious hit Friday from the ISM services index, which jumped from 52.9 to 57.1, the strongest in five

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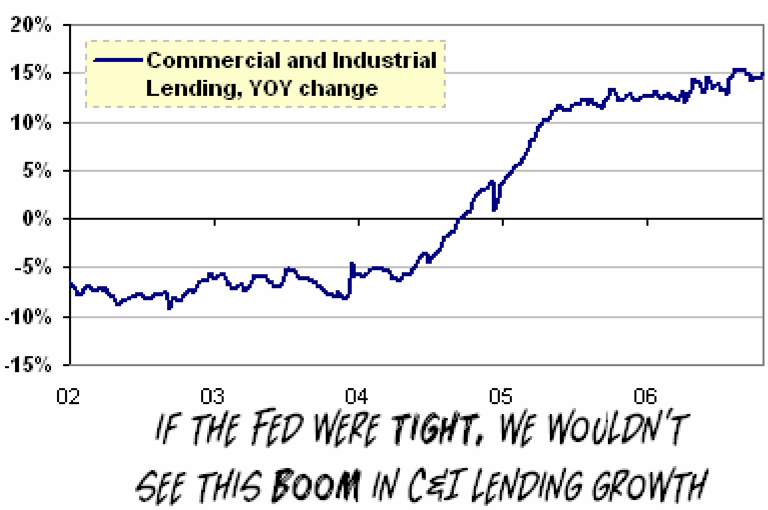
months. The ISM services index is still considered by some a weak sister to its more established manufacturing counterpart. But it measures two thirds of the economy, and is showing results consistent with a still-vibrant economic climate which also continues to be the message in other market-based indicators of risk preference and growth expectations (see "Gut Check For Growth" November 2, 2006").

Part and parcel of the notion that the economy is heading into a slump forcing the Fed into an easing posture is the idea that, after its two-year run of rate hikes, the Fed is too tight. While in absolute terms an upward adjustment of 425 basis points in the overnight rate target can be considered "aggressive," the fact is the Fed was normalizing rates from a hyper-accommodative 1% starting point, and there is scant evidence to suggest that liquidity has become scarce. While gold and oil prices have come off their highs of several months ago, a broader sampling of commodities certainly shows no inkling of tight money. The CRB spot index, which excludes oil and gold, is at all-time highs, up 17% for the year. And while gold rolled back from its quarter-century highs above $700 last spring, it has rallied back by some $60 from below $570 early last month. If Fed policy were anything that could be considered tight, the gold price would be steadily moving back toward around $400 -- which was where it stood prior to the ultra-easy policy phase -- not rallying.



Were liquidity scarce, it's also not likely we'd be the witnessing the ongoing boom in commercial and industrial lending. C&I loan growth, at better than 15% year-on-year, is running at rates not seen since the mid-1980s. At the same time, high risk credit spreads remain near historic lows, an indication both of strong growth prospects and a still accommodative policy environment. Indeed, the Fed holding rates at below-equilibrium levels is, for now, a factor continuing to support a solid growth outlook.

Inevitably, that will change, and the Fed will be forced to confront the consequences of its long run of easy money. In some sense, we were pleased to see the acknowledgment by Dallas Fed President Richard Fisher that "poor data" -- specifically, an underestimate of core inflation -- led the Fed to take too easy a policy stance for too long in 2003 and 2004. At least it represented some acknowledgement of error. More than bad data, however, the Fed is plagued by bad models, which tell it that inflation is a function of real factors such as "resource utilization" and capacity availability, rather than excess monetary liquidity. In October 2003, for example, Ben Bernanke, who at that time was a leading voice at the Fed in setting out an anti-deflationary agenda, asserted that "monetary policy can afford to maintain its accommodative stance for a considerable period, certainly until a sustainable recovery in employment is under way and disinflationary risks have been correspondingly reduced." At about the same time, we anticipated that the deeply lagging statistical core inflation indexes were bottoming out and would soon be headed higher, based on market price indicators of real dollar value (see "Desperately Seeking Inflation" October 30, 2003). The Fed went on hold in August this year guided by the same fundamentally flawed output gap thinking that motivated its misplaced concerns with nonexistent deflationary pressures in 2003. Now, it wants to tell itself that "moderating" growth will lead to an easing of inflationary pressures. Thus, we can take no particular comfort that Fisher's nod to reality implies that policymakers are any less wedded to unsuitable backward-looking policy guideposts.

BOTTOM LINE: October jobs data took a big bite out of the hard landing scenario, but bonds remain priced for as much as 50 basis points in Fed rate cuts. We see that as highly unlikely, and continue to believe the Fed will inevitably be compelled to return to rate-hiking mode as its long-held posture of monetary accommodation continues to feed into rising core inflation. TM