TrendMacrolytics

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

MACROCOSM

Wishful Thinking Has Its Limits

Wednesday, December 13, 2006
David Gitlitz

Good economic news and a steady Fed will inexorably grind down the bond bulls.

Update to strategic view
FED FUNDS: Futures markets show the consensus still expects at least one rate cut in the first half of 2007. With the better-than-expected economic news we forecasted beginning to come in, those expectations will be revised over the coming weeks, and into the first quarter of 2007, in two steps. First, expect no cuts -- then, expect hikes. **US BONDS:** As expectations for rate cuts are abandoned over the coming weeks and into the first quarter of 2007, bond yields should continue to rise from their overly bearish and overly dovish lows of the last several weeks.
[see Investment Strategy Dashboard]

No sooner had the bond market perma-bulls spied what they fancied as some inkling of support for their far-fetched notions that the Fed is poised to begin cutting rates early next year, when today's impressive retail sales report brought an unwelcome dose of reality, pulling the 10-year yield back into the high 4.50s after it breached the 4.5% level in post-FOMC trading Tuesday. At this point it would be premature to declare that the market's penchant for wishful thinking is necessarily over. But going forward we see bonds facing considerable downside risk as the bet on the Fed moving into rate-cutting mode by next spring becomes increasingly untenable. By then, in fact, it's entirely possible that the Fed will be signaling that its next rate move will be higher, not lower.

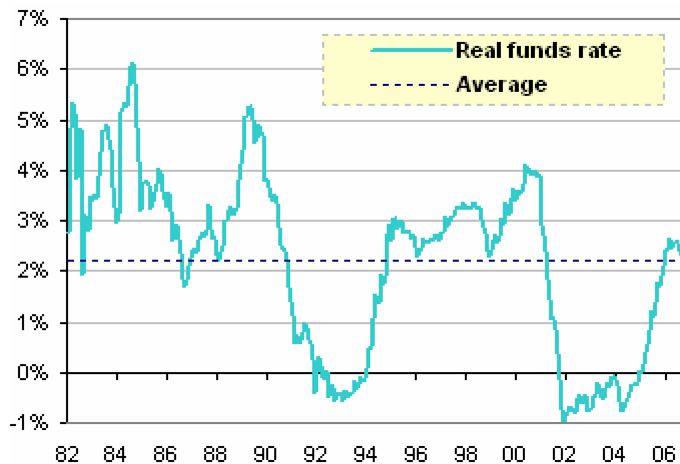
Indeed, it's only with rose-tinted glasses that yesterday's FOMC statement could be read as buttressing the bond bulls' case. While adding the word "substantial" to its characterization of a "cooling" housing market, the statement otherwise maintained the policy panel's emphasis on an "elevated" level of core inflation, and repeated its warning that "inflation risks remain." The economic bears might have wanted to hype the Fed's acknowledgement of the struggling housing market, but it didn't change the committee's view that the economy is poised to continue expanding at a "moderate pace." And the bias to resume raising rates clearly remains in place, as the statement concluded by once again referring to the framework for considering the "extent and timing of any additional firming that may be needed." There was no comparable mention of the possibility of ease.

The policy statement also repeated the assertion made in the previous statement that "inflation pressures seem likely to moderate over time," again citing factors including the drop in energy prices, slower growth and "the cumulative effects of monetary policy actions." This hope, however, is unlikely to be borne out. No such moderation can be seen in sensitive market gauges of dollar purchasing power. The dollar this year has lost about 20% of its value against gold and non-energy, non-precious-metals commodities (the CRB spot index is near all-time highs), and more than 10% against key currencies, including the Euro. Meanwhile, relative to core inflation, the real funds rate is currently running around 2.5%. While this is slightly higher than the long-term average of about 2.2%, the real funds rate remains well below levels that have customarily been employed by the Fed to subdue inflationary flare-ups. In the last such episode, the real rate reached 5% in early 1989. That cycle also saw core CPI top out at a rate

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
704 552 3625



exceeding 5.5%, a level unlikely to be challenged by the current breakout. Nevertheless, the current core rate, at 2.8%, is up nearly 200 basis points from its lows three years ago, and shows no serious signs of a trend reversal. It's not likely that a real rate consistent with a largely steady-state policy stance will be high enough to complete the task of quelling current inflationary impulses. It's also worth noting that while the nominal funds rate this year rose by 75 bps, from 4.5% to 5.25%, core inflation has also risen by just about that much, leaving the real rate essentially stable on net.

Another way of viewing the stance of policy is to compare the funds rate to nominal GDP growth. The Fed has historically subdued significant inflation events only after getting the funds rate to a level exceeding nominal GDP. In the first quarter of 1989, that spread reached 135 bps. Currently, the funds rate remains some 75 bps below nominal GDP. And for those hanging on to the belief that the Fed is poised to cut rates, consider that in the past 20 years, the central bank has never begun a rate-cutting exercise without first putting the funds rate above nominal GDP growth.

As for today's blockbuster retail sales number, the 1% monthly gain means that in the first two months of the fourth quarter, real retail sales are running at a better-than 7% annualized pace, which bodes well for GDP growth in the quarter significantly exceeding the dour sub-2% forecasts of much of the economic cognoscenti. In the past few months, when overall retail sales growth was held down by the sharp decline in gasoline prices, the pessimists' view was that the data was evidence of sluggish consumption because otherwise growth of sales in other areas would have offset the decline in gasoline. Today's report suggests that those gasoline savings are showing up in consumption more broadly.

BOTTOM LINE: The bond market's ability to capitalize on a purportedly more-dovish stance from the FOMC yesterday turned out to be short-lived, as today's surprisingly robust retail sales report sent a shiver down the spine of the bond bulls riding the wave of hope that Fed ease awaits just around the corner. Eventually, all waves crash into the beach, and this one will be no different. In fact, yesterday's FOMC statement gave no quarter to the rate-cut enthusiasts, and prospects for a significant growth pickup are only likely to move forward the date when the Fed can confidently turn away from its ill-advised rate pause and return to the still-incomplete task of quashing the evident inflationary influences that remain in place.TM