TrendMacrolytics

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

MACROCOSM

Keeping the Cheering Down

Monday, January 29, 2007
David Gitlitz

The Fed's been wrong about the slowing economy -- but they're unlikely to admit it at Wednesday's FOMC meeting.

The extended run of stronger than expected data the past several weeks is shifting the ground under the feet of the bears who were certain that the economy was entering a downturn that would compel a fairly aggressive easing response from the Fed. As the FOMC prepares to gather this week for its first policy session of the year, the market has taken out more than 80% of its rate cut bet for the year, and the dour pessimists who compose the Wall Street economic consensus are ditching their slow growth forecasts.

The extent to which the Fed is prepared to acknowledge this stronger growth reality, however, remains an open question. Coincident with the decision to put its rate hiking exercise on hold last August, the Fed adopted the view that a cooling housing market would help precipitate a slowing in growth, which it saw leading to a "moderation" of inflation pressures. While continuing to cite inflation as their dominant concern, policymakers have also pointed to the apparent slowing in growth as seeming to confirm their judgment about the suitability of their current stance. To be sure, the Fed's outlook has been considerably more positive than the bearish view of much of the economic cognoscenti, and its stated bias has remained toward further tightening. But an overt shift in the central bank's take on the economic climate could signal that the Fed is closer to returning to rate hiking mode than it is prepared to allow for at this point.

That concern was evident in a report in Friday's *Wall Street Journal*, which cited "Fed officials" as believing the "housing downturn has yet to show its full impact on the economy. As it does, they expect growth to remain slow and unemployment to rise, hastening the recent downtrend in inflation." In fact, the continuing strength of the labor market presents a conundrum for the Fed. Under its faulty demand management framework, "the longer unemployment stays low, the greater the likelihood that fear of accelerating wages and prices will prompt officials to contemplate an interest-rate increase," the *Journal* noted. The stubborn

Update to strategic view

FED FUNDS: At this week's FOMC meeting, the Fed is unlikely to fully acknowledge the true extent of the reacceleration of growth, nor the likely persistence of elevated levels of inflation. The FOMC's signal to the market will likely be "on pause as far as the eye can see." But within months, we expect a more hawkish message, with the next rate move being a hike, not a cut. **US BONDS:** Yields have already risen 50 basis points from the lows as rate cut expectations have come out of the market. Bonds are likely to find support near here, as the FOMC this week is unlikely to point overtly to higher rates. As growth reaccelerates and inflation persists, the Fed's tune will turn more hawkish and bonds will take their next leg down.

[see Investment Strategy Dashboard]

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

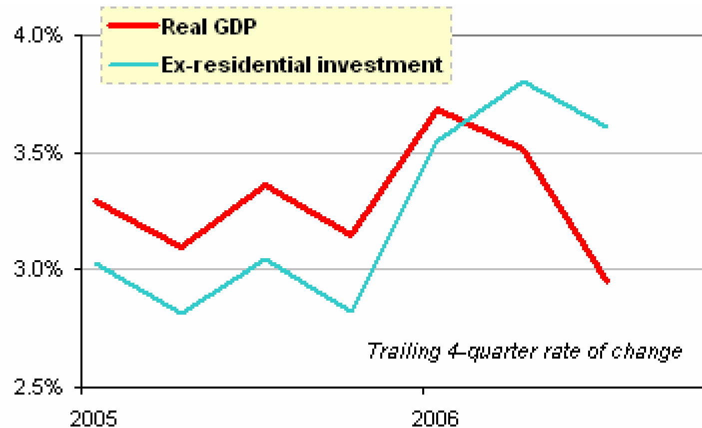
Offices:
Menlo Park CA
Parsippany NJ
Charlotte NC

Phone:
650 429 2112
973 335 5079
704 552 3625

Copyright 2007 Trend Macrolytics LLC. All rights reserved. This document is not to be forwarded to individuals or organizations not authorized by Trend Macrolytics LLC to receive it. For information purposes only; not to be deemed to be recommendations for buying or selling specific securities or to constitute personalized investment advice. Derived from sources deemed to be reliable, but no warranty is made as to accuracy.

robustness of job growth appears to be flummoxing our central bank. The story quotes San Francisco Fed president Janet Yellen positing that there is "an emerging puzzle in the data: Why is the labor market apparently going gangbusters, while growth has turned in only a middling performance on average in recent quarters?" Among the range of explanations, Yellen cited the "worrisome" possibility that the economy's "growth potential" is considerably less than the sub-3% rates currently estimated by the Fed, meaning that the current tightness of the labor market raises the neo-Keynesian specter of "excess aggregate demand." But Yellen said she thought the more likely explanation is that the labor market is lagging behind the general economy, and that unemployment will soon move higher.

This analysis, however, misses the point. The fact is, the housing downturn has been entirely contained within the housing sector, and whatever small risk might have been posed to the broader economy is now washing out as signs continue to emerge that the residential real estate market is stabilizing. Employment growth has remained strong because the economy, for all the *sturm und drang* about housing, has remained strong. The attached chart plots real GDP growth versus growth ex-residential investment. As can be seen, four-quarter growth ex-housing the past two quarters has been even stronger than overall growth in the vigorous expansion pace through early last year. More likely than not, the 1.2% drag on growth in last year's third quarter represented the height of the housing effect. As it is, the data Wednesday should show fourth quarter GDP posting real growth of about 3%. Going forward, as the effect of the housing drag on reported growth continues to diminish, a return to 3%-plus growth rates appears entirely within reach.



THE HOUSING SLOWDOWN HASN'T KEPT THE REST OF THE ECONOMY FROM BOOMING

And if the Fed isn't going to get bailed out on the growth front, neither is inflation likely to conform to its hopes. We reject the conventional doctrine that holds that inflation is a function of real resource utilization factors. Inflation is a consequence of a decline in the dollar's real purchasing power owing to an excess supply of monetary liquidity relative to demand. After 425 basis points in rate hikes in the two years ending last June, the most sensitive market indicators that we monitor -- including gold, broader commodity indexes and foreign exchange -- continue to point to the Fed remaining in an excess liquidity posture. We also make note of a recent acceleration of

THE GLOBAL LIQUIDITY GLUT -- IN THE FED'S SHELTER FOR HOMELESS DOLLARS

another measure of liquidity which appears on the Fed's balance sheet as custody holdings for foreign central banks. This item essentially reflects the status of dollar demand in the global financial system. During the Fed's deflation of the late 1990s, the Fed's custody holdings shrank as central banks liquidated dollar assets to meet surging dollar demand. Since the Fed went into its easy money, surplus liquidity posture in 2002, these holdings have more than doubled and now stand at nearly $1.8 trillion. As of the most recent statement last week, the Fed's custody holdings have risen by more than $24 billion in the past year, the most accelerated year-on-year increment in more than two years. This can be seen as a measure of the dollars that come back to the Fed after feeding through the international financial plumbing and winding up as excess on the doorstep of foreign central banks. Often, these balances show up at the Fed after intervention by central banks to drain the excess dollars from their markets to keep their currencies from appreciating against a weakness-prone dollar.

BOTTOM LINE: The economic consensus may be turning toward a more upbeat outlook, but for now the Fed appears content to keep a damper on its assessment of the economic climate. Apparently, policy makers at this point want to refrain from signaling that they are prepared to return to rate hiking mode, and are seeking rationalizations to maintain a somewhat dreary perspective. More than likely, however, this will turn out to be a short-lived interlude, and in fairly short order the central bank will be compelled to acknowledge more rapid growth and inflation, pointing to the inevitability of a resumption of the rate hiking exercise. Until then, bonds might find some level of support at around current levels, having seen the 10-year yield soar by some 50 basis points since early last month. But from any longer term perspective, bonds remain a bad bet, as both the inflation and policy reality come into clearer focus. TM