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

MACROCOSM

Flex Time

Friday, March 30, 2007

Donald Luskin

Today's data should begin to bend the "flexible" Fed toward the breaking point.

For all the debate about what the Fed will or ought to do with rates, the underlying realities are actually quite simple. Inflation is already higher than the Fed wants. There is no evidence that it is moving lower, and much evidence that it is moving higher. All else equal the Fed would be hiking rates right now to deal with it. Growth is being held back by housing; abstracting from that, the economy is booming. The only risk to growth is that the housing "adjustment" will spill over into the overall economy. There is no evidence that it is doing so, and much evidence that it is not (see "All Tip, No Iceberg" March 16, 2007). Yet the Fed fears that it *might*, so it is holding rates where they are, despite its inflation concerns -- this being what Bernanke, avowedly an "inflation targeter," meant in his congressional testimony this week when he said "a little more flexibility might be desirable" (see "Both Sides Now" March 28, 2007). Translation: *a little more inflation will be necessary*.

Update to strategic view

US MACRO: This morning's income and spending data confirms that the housing "adjustment" is not infecting the overall economy. And this morning's inflation data, putting core PCE growth back almost to cycle highs, confirms that inflation is growing, not moderating. This is confirmed by sustained rallies in all the forward-looking market-based inflation indicators.

FED FUNDS: We remain convinced that the next Fed rate move will be higher, based on our expectations for strong growth and rising inflation. With the Fed obsessing over increased risks "on both sides," the current pause will only end when the data compels the Fed to act, and at this time we can't say when that will be. But it is virtually certain that the market's expectations for rate cuts will be defeated.

[see Investment Strategy Dashboard]

That's what we're getting. With this morning's core PCE report, the Fed's most closely watched inflation measure now stands at 2.4% year-on-year growth, within a hair of the highs of the current cycle. At this level, core PCE is higher than it was last June when Ben Bernanke gave the most hawkish speech of his career, characterizing the then-current level of inflation with one of the strongest words a Fed chairman ever uses: "unwelcome" (see "Bernanke Arrives" June 6, 2006). The most recent FOMC statement was unambiguous that the "predominant policy concern remains the risk that inflation will fail to moderate as expected" (see Huh?" March 22, 2007). It's getting to where that's not really a "risk" anymore -- it's a certainty. Since mid-January all the market-based forward-looking inflation indicators -- such as oil, gold, the TIPS spread, and foreign exchange -- turned higher. That was when the subprime crisis first started being discussed, and it began to emerge that the Fed would be exercising "a little more flexibility" to insure against it (see "Subprime Time" February 26, 2007).

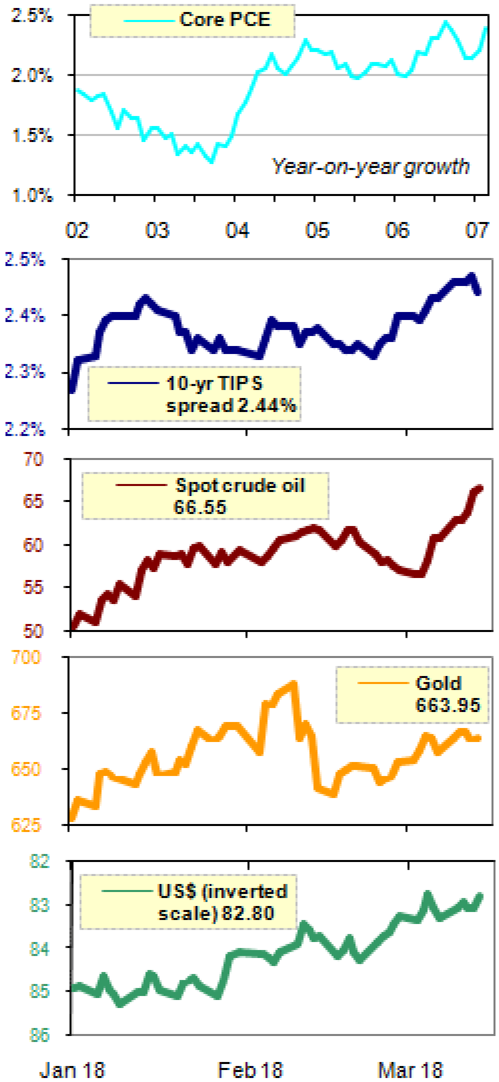
http://www.trendmacro.com
don@trendmacro.com
dgitlitz@trendmacro.com
tdemas@trendmacro.com

Offices:
Menlo Park CA
Parsippany NJ
Charlotte NC

Phone:
650 429 2112
973 335 5079
704 552 3625

As the subprime crisis has come to prominence, and the Fed has confirmed that it is weighing it heavily in its risk calculus, the inflation indicators have continued to move higher.

IT'S UNANIMOUS -- "INFLATION WILL FAIL TO MODERATE AS EXPECTED"



From our standpoint, this makes it a virtual certainty that, within the next couple months, all the official core inflation statistics will be reporting at new cycle highs.

At the same time, we are confident that the risks to growth contemplated by the Fed will not materialize. Here, too, today's data was compelling. This morning's personal income and spending numbers for February not only far surpassed expectations, but can only be regarded as having come in at boom levels. The conventional wisdom that rising delinquencies in the subprime sector necessarily indicate a consumer retrenchment seem to be flatly untrue. At the same time, the Chicago PMI turned in its best monthly gain in history. And construction spending -- housing "adjustment" or not -- reported its best gain in eleven months. All these datapoints are all the more compelling considering the weather in February, which had more workers missing work than at any time in the last quarter century.

BOTTOM LINE: The realities are simple. Growth is in good shape, and inflation is getting worse. But the Fed is complex, as is any human institution. We do not know when, in their risk management framework or their political calculus, they will be willing to act on the inflation risk they admit is "predominant," and elect not to exercise so much "flexibility" in deviating from their price stability mission for the sake of insuring against remote growth risks. We do know that the Fed's "flexibility" is exacerbating the "predominant" risk -- and that the Fed can only be so flexible for so long, before it finally breaks. We are now more convinced than ever that the Fed will break on the side of rate hikes, as evidence of rising inflation continues to come in, and evidence of a failing economy continues to fail to materialize.