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MACROCOSM

Growth Returns in the Spring

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After a dreary winter, the economic bears may have to stay in hibernation.

If every bear has its day, last Friday's feeble-looking first quarter GDP release may well come to be seen as the high (or is that low?) point for the dour view that this economy is fated to remain on an extended downtrend. Reported growth has been distorted significantly by the effects of the continuing but isolated housing contraction (see "Two Economies, One Funds Rate" May 1, 2007), but the 1.3% rate registered as a glum note on an economy that has seen its four-quarter pace of expansion downshift from nearly 4% to just above 2% since last year's first quarter. But after a dreary winter, it now appears that our steadfast prediction (and Chauncey Gardner's) that growth will return in the spring has come true. Particularly encouraging in that regard have been the ISM indexes showing an acceleration in both the manufacturing and services sectors, another healthy uptick in non-residential construction spending, and a decline in jobless claims indicating that the labor market is showing no signs of slack.

Update to strategic view
US MACRO: Recent evidence points to a resumption of brisk growth, which is likely to disappoint both the economic bears in the market and the hopeful doves on the Fed. Internals in this week's ISM reports suggest that the inventory overhang of the last two quarters has been worked off, non-residential construction spending is booming, and the jobs market remains tight.
[see Investment Strategy Dashboard]

The ISM releases are probably the best barometers of contemporaneous conditions available, and after several lackluster readings, both indexes returned to positions solidly above the break-even 50 line (54.7 for manufacturing, 56 for services). One month does not make a trend, but both indexes were backed up by forward-looking indications that the monthly readings were likely not outliers. New orders rose smartly for both, and respondents to the manufacturing survey reported that after nine consecutive months of declining inventories, supply chains are now in balance, indicating that the inventory overhang has been worked off, leaving room for production to ramp up in the coming weeks and months.

We also were encouraged by the latest construction spending data which, even with the drag of housing, has shown some marginal growth over the last two months. On net, in fact, total construction spending is only down about 3% since housing peaked early last year. This has been explained by the acceleration of non-residential construction, which is now registering all-time highs, showing year-on-year growth of 16.5%. This accords with our view that in many ways the end of the housing boom actually removed an artificial distortion from the economy,

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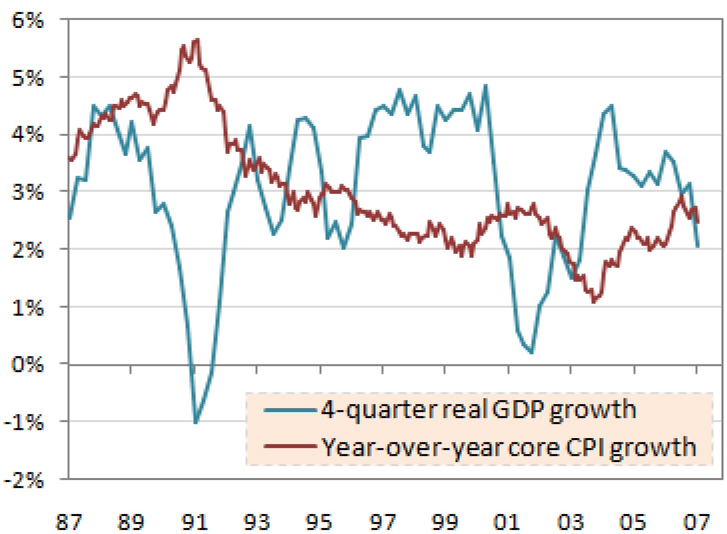
allowing resources to be allocated on a more economically rational basis, seeking their highest and best uses.

Jobless claims, meanwhile, dropped another 21,000 in the last week to 305,000, which is the lowest level since early this year and represents a complete reversal of the minor uptick of the past few months.

In this environment the relevant issue raised by evidence of a swing toward more upbeat economic results is the effect it's likely to have on monetary policy, with policymakers having sought to position themselves as hawkish on the inflation front while at the same time content to appear at least marginally dovish in expressing their perception of potential downside economic risks. At this point, policymakers appear to accept the inconsistency of this posture as inevitable given the uncertainties they believe they currently face. In a conversation this week with an FOMC member, we were struck by the extent to which one policymaker -- and one who usually is identified as a "hawk" -- seemed willing to accept current core inflation levels, notwithstanding their being cited repeatedly as unacceptably high, as insuring against the risk of deeper economic weakness that could result from additional tightening. He acknowledged that core rates could still move higher, but also was content to posit the Fed's "output gap" rationale, that slower growth would eventually pull inflation lower, thereby allowing the Fed to avoid having to return to the rate-hiking exercise.



THE INFLATION/GROWTH CONNECTION -- A BELIEF UTTERLY WITHOUT EMPIRICAL SUPPORT

In fact though, the Fed's rationale is a common supposition in search of even the slightest empirical support. The accompanying chart, tracking GDP growth against core CPI over the past 20 years, reveals the lack of any positive relationship. At key points, in fact, the relationship has clearly been inverse -- as the growth deceleration in the early 1990s corresponded with accelerating inflation, while the brisker growth of the late 1990s was accompanied by falling inflation. Regression analysis produces a squared correlation coefficient of less than 10% between the two variables, even assuming substantial lags, which suggests virtually no relationship between the two.

BOTTOM LINE: Next week's FOMC meeting comes against the backdrop of a recent turn toward more upbeat economic data, but it's unlikely to have much impact on the assembled policymakers. While aware of the ambiguity of its current outlook, the Fed at this point perceives no prod to move off its current stance. Our bet remains that some combination of stronger than expected growth and higher than tolerable core inflation will inevitably move them back into tightening mode. That eventuality, however, remains a distant prospect from the perspective of an avowedly "data dependent" central bank. But while we cannot make the case for a *near-term* Fed return to rate-hiking, at this point there is no conceivable rationale for the Fed to consider resorting to an easing stance. Fixed income markets still pricing for that prospect face an inexorable awakening to reality.