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MARKET CALLS

Doves Eat Crow

Wednesday, June 6, 2007

Donald Luskin

They admit it finally -- no rate cuts. But that won't hurt growth, so a stock market correction will be short-lived.

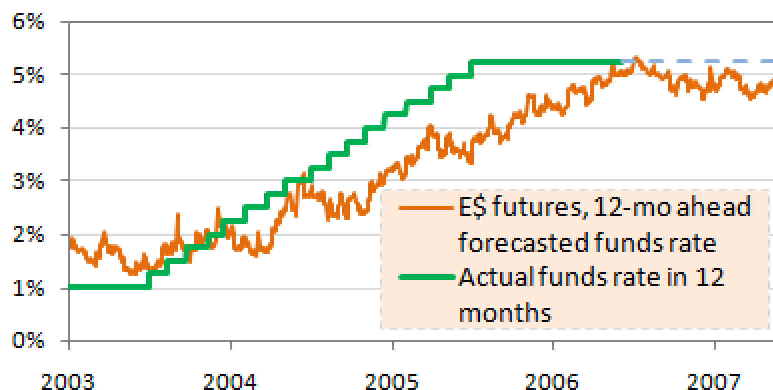
The conventional wisdom has decisively shifted. One by one over the last week, the pillars of the economic establishment have bowed to the fact that the Fed is not going to cut interest rates. The Eurodollar futures markets are now forecasting, essentially, that the Fed will be on hold at 5.25% forever. Hats off to our iconoclastic chief economist David Gitlitz, who has maintained steadfastly from the very beginning that there would be no rate cuts (see, among many examples, "Denial" September 5, 2006). If we have erred, it has been to expect that the Fed would have *raised* rates by now. We continue to expect that the next move from the Fed will be toward higher rates, and we see the present shift in consensus away from expected rate cuts as a down-payment on that ultimate realization.

Update to strategic view

US STOCKS: The correction we have expected has begun, as the consensus for Fed rate cuts has decisively capitulated. We don't think growth will be damaged by a Fed that stays on hold here, or that hikes rates a couple times starting in the fourth quarter. We expect any correction here to be short-lived, and a buying opportunity.

[see Investment Strategy Dashboard]

An immediate consequence of the shift in consensus away from rate cuts is a correction in stocks, which we have been expecting for a couple weeks (see "Upside Surprise on Trade" May 14, 2007). We expect that this will be nothing more than a correction, and in a matter of days or weeks stocks will have recovered to new highs when it is understood that growth was never contingent on rate cuts to begin with, and indeed that growth would not be damaged by a couple of judicious rate hikes.



There will indeed be rate hikes. Today's consensus that the Fed will stay on hold forever will prove to be as wrong as the previous consensus that there would

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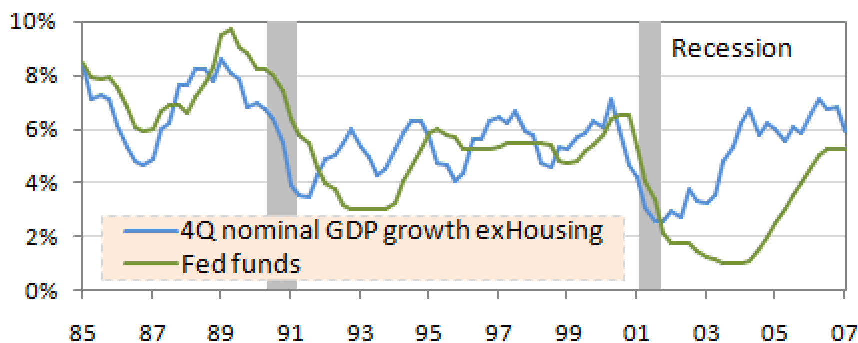
be rate cuts. We expect that the first rate hike won't come until the fourth quarter, as evidence of the reacceleration of economic growth shifts the Fed's decision-making structure such that (1) the threat of systemic weakness stemming from the housing adjustment has passed, and (2) absent a moderation in growth, inflation cannot be expected to drift back down into the Fed's "comfort zone." In such an environment, a couple of rate hikes would move policy close to equilibrium, but policy would still not be tight. At say 5.75% or 6.00%, the funds rate would likely be sufficient to stop imparting new inflationary impulses, but would not be sufficient to damage the economy. There is the possibility -- indeed, the probability -- that the Fed will not choose to stop at mere equilibrium, and through error or design will move beyond it to tightness sufficient to actively reverse inflationary impulses, with the risk of damaging the economy.



But for now that threat is over the horizon. Today markets only have to deal with a simpler and entirely benign situation: a shift in consensus that there will be no rate cuts, occurring in a strong economy that never needed rate cuts to keep on growing in the first place. The pillars of the economic establishment who have wrongly expected rate cuts did so because they couldn't see through the mask of weakness created by the housing sector, a mere 4.5% sliver of the economy that has performed so poorly as to drag down overall reported growth. Stripping away that mask, the general economy -- the 95.5% that is not housing -- has been quite strong. As the chart at left shows, a 5.25% fed funds rate is not restrictive at all in relation to nominal GDP growth ex-housing. It may be too high a rate for the crippled housing sector, but it is actually somewhat accommodative for the vast majority of the economy. That is especially true now that the economy has decisively recovered from a mid-cycle slowdown that bottomed in February/March (see "Rodney Revisited" May 29, 2007).

BOTTOM LINE: Stocks have come a long way this year, making new highs as forward earnings recovered from their February/March pause -- even as long term interest rates have risen, and expectations for Fed rate cuts have evaporated. It's been time for stocks to take a rest for several weeks, and if the new conventional wisdom that the Fed won't cut rates is to be the catalyst for its onset, then so be it. But by staying on hold for several more months, the Fed remains somewhat accommodative and is no threat to growth. Even a couple of rate hikes, in the context of resurgent broad-based growth, would not be an immediate threat. Based on what we know now, we expect the present correction in stocks to be a buying opportunity.