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FED SHADOW

Hikes Are Coming, and Not a Moment Too Soon

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Despite the chatter, an improving economy and rising inflation point to a higher funds rate.

There's been a lot of talk this week about the Fed giving the markets serious second thoughts about prospects for an early start reversing the 325 bp rate-cutting exercise that began last September. But fed funds futures are still fully priced for 50 bp in hikes by October, and are showing about an even-money bet on an additional 25 bp by year-end. The 2-year Treasury yield, having jumped above 3%, has dropped back to around 2.90%. That's a modest scaling back in rate hike expectations from their peak at the beginning of the week, but it still represents a striking shift just since two weeks ago, when the futures curve was fully priced for just one 25 bp rate hike by December, with the 2-year noted yielding less than 2.4% (see ["This is the Turn"](#) June 11, 2008).

The Fed is talking much criticism for its clumsy communications strategy. The market began pricing in a succession of rate hikes when a series of speeches by Fed chairman Ben Bernanke highlighted his growing concern about the inflationary implications of a weak dollar and rising inflation expectations (see ["The Bernanke Awakening"](#) June 5, 2008). But it seems that while the Fed intended to alert the market to this shift in thinking, implying that rates would be going up a lot sooner than had previously been anticipated, the extent of the market's rate hike expectations went beyond its comfort zone. It signaled, through plants in the financial press, that concerns about the health of the economy and fragility of the markets remained factors in the policy outlook, and thus their posture was not quite as aggressive as the markets perceived. This episode may have left a lot to be desired for adroit messaging, especially in contrast to the elegance of the Greenspan method, but our sense is that the markets are now pretty well aligned with the Fed's perspective, or at least its perspective at the moment.

So all the chatter suggesting that the Fed has taken the rate hike option off the table at least through the fall is seriously misguided. The Fed may have some lingering worries about the strength of the economy, but for the most part the data has been consistently pointing toward recovery, not retrenchment. Core retail sales are growing at a 10% annualized rate the past

Update to strategic view

FED FUNDS: We are not persuaded by the new popular view that the Fed will pause at a 2% funds rate for the remainder of the year. We continue to think that the first 25 bp hike could come as early as the August FOMC meeting, and that the funds rate will be 100 bp higher by year-end.

[\[see Investment Strategy Dashboard\]](#)

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three months, new non-defense capital good orders at 8.3%, non-residential construction by nearly 17%, and exports by about 20%. After two quarters of sub-1% real GDP growth, the current quarter appears on track for a growth rate in the neighborhood of 2%. At the same time, more forward-looking indicators such as credit spreads suggest the continued restoration of the market's capacity to bear risk, after risk tolerance was shut down during the credit market crisis. For example, after spiking above 860 bp in mid-March, the Merrill High Yield Index spread has narrowed by more than 200 bp.

Moreover, the notion that Fed rate hikes from the current ultra-low 2% level would represent a threat to growth is simply fallacious. The real -- that is, inflation-adjusted -- rate is *negative* 2%, meaning the Fed would have to raise rates by about 400 bp just to restore a "normal" real rate of about 2%, the average of the past 25 years. Historically, monetary tightening has not impinged on growth at a real funds rate below 4%, which obviously is a long way from current reality.

Maintaining such a low real rate entails substantial risks of its own, as it reflects the Fed's easy-money policy posture, embedding inflationary impulses which have only begun to surface in lagging statistics. Many analysts and pundits remain willing to write off high headline inflation data as being heavily influenced by food and energy, which are seen as exogenous to underlying inflation fundamentals. This week, for example, the Producer Price Index showed a 1.4% monthly jump, up 7.2% in the past year, but this was widely discounted as a food and energy story against the more comforting 0.2% gain in core PPI. But a closer look at the core index suggests such comfort might be misplaced. On a year-over-year basis, the core rate is running at about 3%, and has been in a steady uptrend since the first quarter of 2007, which ended with the 12-month rate at about half the current reading.

We'll get a more complete reading on the Fed's perspective next Wednesday afternoon when it releases the post-FOMC statement. It's expected that while the statement will elevate the panel's cognizance of inflation risk, it will still refrain from adopting a symmetric bias toward tightening, thus keeping the markets off guard about the outlook for the next meeting in August. But that could be a tough nut to crack, as markets likely will read a reflection of deepening concern about the inflation outlook as indicating that rate hikes are likely to begin sooner rather than later.

BOTTOM LINE: In the larger scheme of things, the scaling back of rate hike expectations which has garnered so much attention the past few days appears not so momentous. August fed funds futures, which at the beginning of the week were nearly fully priced for the first 25 bp hike, are now showing about a 50% chance. The September contract is showing more than a 100% probability for the first hike coming that month, and the curve out to year end has only modestly pulled back, pricing for a better than even chance that the funds rate will end the year at 2.75%. We continue to lean toward the more hawkish side of the outlook, seeing the Fed as having diminishing opportunities to avoid the inevitable. Our view remains that rate hikes will begin in August, and we still see a good chance that the funds rate could be as much 100 bp higher at year-end. ▶