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Jun 19, 2006

Monday Morning Outlook

Date/Time (CDT)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
6-20 / 7:30 am	May Housing Starts	1.850M	1.87M		1.849M
6-22 / 7:30 am	Initial Unemployment Claims	306K	301k		295K
9:00 am	May Leading Indicators	-0.4%	-0.4%		-0.1%
6-23 / 7:30 am	May Durable Goods Orders	+0.8%	+1.7%		-4.4%

Market-Based Indicators and the Fed

Monetary policy impacts the economy with what Milton Friedman called a "long and variable" lag. There is general agreement that this lag is roughly six to nine months for economic growth and 18 to 24 months for inflation.

The length of these lags makes it difficult to manage monetary policy by watching general measures of economic activity or inflation. By the time the economy slows, monetary policy has already been tight for at least six months. And when inflation is on the rise, it is reacting to easy money from maybe two years before. In fact, because of the mismatched lags, tightening could cause the economy to slow even though inflation continues to climb.

This is exactly what some are worried about in 2006. They believe that by pushing rates up from 1.0% to 5.0%, the Fed has tightened enough to cause the economy to slow. As a result, they are encouraging the Fed to ignore rising inflationary pressures.

This creates a great deal of uncertainty about the management of monetary policy. If the Fed keeps tightening until the economy actually slows down, or until inflation peaks and starts to fall, it has likely tightened too much.

If the Fed thinks the economy is slowing and "pauses" in its rate hiking campaign, but the economy is not slowing, then it can find itself behind the curve and inflation will move even higher. In other words, using economic data can cause the Fed to undershoot or overshoot.

Market-based indicators avoid these problems. When the Fed is printing too much money, commodity prices rise and the dollar falls. This happens almost immediately because foreign exchange and commodities markets are extremely sensitive. A change in the amount of dollar liquidity (or even the perception of a shift in policy) impacts these markets virtually in real time.

In the late 1990s, the dollar was strong and commodity prices were weak. These markets clearly signaled that the Fed should not tighten. However, because the economy was growing strongly and the stock market was booming, the Fed thought that monetary policy should be tightened. This tightening caused a recession and deflation. Market-based indicators sent the right message, but the Fed ignored it.

In the past few years, commodity prices have risen substantially and the dollar has weakened. These markets have clearly indicated an overly accommodative Fed policy. Moreover, they are very sensitive.

In mid-April, with gold trading near $595/oz. and the dollar having strengthened for the past year, the market began to believe that the Fed would "pause" at 5.0%. Almost immediately, the dollar began to weaken and gold prices started to climb. Gold eventually shot to over $730/oz. In addition, the TIPS spread began to widen. Each of these signaled that the market thought a pause at 5.0% would generate inflationary pressures.

Fed Chairman Bernanke reacted to these market signals, and very publicly assured the markets that the Fed would not pause at 5.0%. He suggested that the Fed would be "vigilant" in its fight against inflation. Immediately, the dollar stopped declining and strengthened slightly, gold prices plummeted and fell back below their mid-April levels, while the TIPS spread began to narrow.

Chairman Bernanke referred to these markets last week when he said that market-based inflation expectations had "fallen back somewhat." What he did not say was that inflation was contained. It will not be contained until the Fed follows through and pushes the federal funds rate to neutral, which we estimate is 6.0%. But this is not an exact science. If the Fed tightens to 5.5%, and market-based indicators signal that policy is tight enough, it will be time to stop. The Fed is very close and markets are very sensitive indicators of just how close. But the best news of all is that the Fed is watching these markets to assess its policy stance. Nothing could be more assuring. Fed policy is in great hands.

Week of June 26, 2006

Date/Time (CDT)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
6-26 / 9:00 am	May New Home Sales	1.168M	1.120M		1.198K
6-27 / 9:00 am	May Existing Home Sales	6.65M	6.70M		6.76M
6-29 / 7:30 am	Q1 Real GDP: Final	5.4%	5.8%		+5.3%
	Q1 GDP Price Index: Final	3.3%	3.3%		+3.3%
1:15 pm	FOMC Meeting	5.25%	5.25%		5.00%
6-30 / 7:30 am	May Personal Income	+0.3%	+0.5%		+0.5%
	May Personal Consumption	+0.3%	+0.3%		+0.6%
9:00 am	Jun Chicago PMI	59.0	61.5		61.5

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