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Monday Morning Outlook

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Bernanke Wants Higher Long-term Interest Rates

If a Fed Chairman drops a bomb during testimony on Capitol Hill and nobody sees or hears it, was it really a bomb?

We ask this question because of the Q&A between Fed Chairman Ben Bernanke and Congressman Jim Saxton during last week's Joint Economic Committee hearing about the current stance of Fed policy.

In it, Chairman Bernanke said: *"We in general prefer not to give advance rate guidance - that is, not to tell the market we're going to do this, that and the other, rather it's better for the FOMC to describe our outlook and the risks we see to the outlook and let the markets make their own determination about how to price assets. And one aspect of this change has been to move away from forward rate guidance, which we view as being something that should be undertaken mostly under unusual circumstances."*

In order to fully understand the meaning of this statement, it is necessary to go back in time to a famous speech on deflation given by then Fed Governor Bernanke in November 2002. This was the speech in which Bernanke talked about dropping money from helicopters, earning him the nickname "Helicopter Ben."

At the time of that speech the Fed had already dropped rates to 1.25%, economic growth was still slow and the Fed was fearful of deflation. In the speech Bernanke discussed options for fighting deflation without cutting the funds rate again, including the reduction of long-term interest rates in order to stimulate growth.

To do this the Fed would need to convince the markets that the future path of short-term rates was lower than the market currently thought. As Bernanke put it; *"Because long-term interest rates represent averages of current and expected future short-term rates…a commitment to keep short-term rates [very low]…would induce a decline in longer-term rates."*

Starting in mid-2003, the Fed felt circumstances were "unusual" enough to begin telegraphing its moves, and it told the market that policy accommodation would be maintained for a "considerable period." As a result, long-term interests rates fell and the yield curve flattened.

Now, with inflation on the rise, Bernanke is looking for a way to reduce inflationary pressures without any further rate hikes. It sounds like he wants to accomplish this by becoming less transparent. By moving away from rate signaling, he hopes increased uncertainty (higher risk) about future short-term interest rates will push long-term rates higher.

This is a strange policy. We have no idea how it will work, but it appears to have already steepened the Treasury yield curve, and will probably result in even more steepening in the weeks and months ahead. In the end, however, the economy and inflation are both on track to be stronger than the market or the Fed expects. We continue to forecast rate hikes in the second-half of 2007, not rate cuts as the market still expects. If that occurs, amidst less rate signaling, long-term interest rates could finally move significantly higher.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
4-2 / 9:00 am	ISM Index - Mar	51.0	**52.7**	***50.9***	52.3
4-3 *sometime*	Domestic Auto Sales - Mar	5.2 Mil	**5.2 Mil**		5.1 Mil
during the day	Domestic Truck Sales - Mar	7.5 Mil	**7.5 Mil**		7.7 Mil
4-4 / 9:00 am	Factory Orders - Feb	2.0%	**2.0%**		-5.6%
9:00 am	ISM Non-Man. - Mar	55.0	**57.1**		54.3
4-5 / 7:30 am	Initial Claims - Mar 31	315K	**317K**		308K
4-6 / 7:30 am	Non-Farm Payrolls - Mar	128K	**216K**		97K
7:30 am	Unemployment Rate - Mar	4.6%	**4.5%**		4.5%
7:30 am	Average Hourly Earnings - Mar	+0.3%	**+0.4%**		+0.4%
7:30 am	Average Weekly Hours - Mar	33.8	**33.8**		33.7
7:30 am	Manufacturing Payrolls - Mar	-10K	**-17K**		-14K