



WILLIAM STERLING

STERLING'S WORLD REPORT



When Will the Fed Take a Break?

We have been relatively optimistic that equity markets could post reasonable gains in 2005 based on our positive outlook for global growth. This view assumes that the U.S. Federal Reserve will not tighten monetary policy too aggressively.

Many global stock markets turned in a disappointing performance in the first quarter. The markets had to contend with yet another spike in the price of oil – this time to a new high of \$57 US per barrel – and with hints that the Fed was leaning toward a more aggressive posture. Fed officials clearly do not want higher energy prices to become a catalyst for across-the-board price hikes in other areas. Various officials have also expressed concerns about frothy housing markets and the nation's massive trade and current account deficits.

So more rate hikes are on the way. The question is how fast and furious they will be. A closely related issue is whether the Fed will stop using language referring to a “measured” pace of tightening – which has basically come to mean one 0.25% rate hike per Fed meeting. As we show in Chart 1, one rate hike per meeting would take the Fed funds rate from its current level of 2.75% to 4.25% by the end of the year. In contrast, the Fed funds futures market is projecting a rate of about 4.0% at the end of the year. That suggests that the markets expect a pause in tightening at some point this year – perhaps when Fed officials go fishing this summer.

In our view, the Fed may be able to take a more extended break in its current tightening cycle – a development that

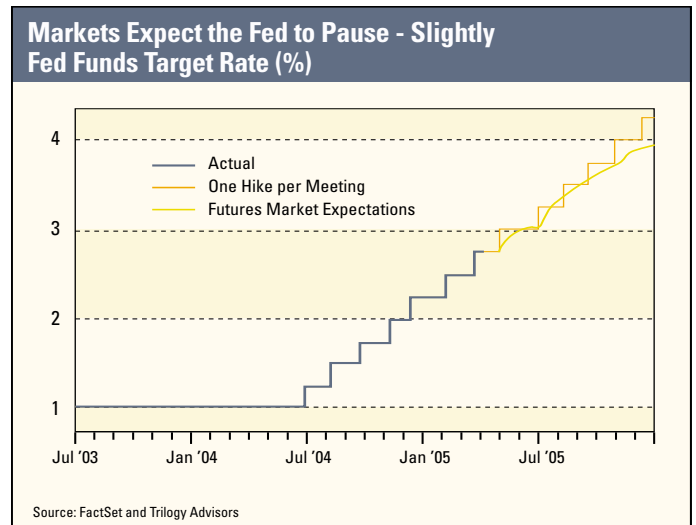


Chart 1: If the U.S. Federal Reserve hikes rates by 0.25% at every meeting, the Fed funds rate would reach 4.25% by the end of the year. The markets expect only a slightly more muted path.

likely will be critical for many global equity markets this year. An extended pause by the Fed would tend to foster expectations that the global economic expansion will be stronger and longer than the markets are currently expecting. Although we would certainly not rule out a Fed funds rate of 4.25% by the end of the year, we believe that a good case can be made that the Fed will decide to pause for some time after the funds rate reaches 3.0% to 3.5%. If we are correct, that suggests that investors will be pleasantly surprised by another year of decent returns.



There are three key reasons supporting our view:

First, the U.S. job market remains lukewarm at best and is showing nothing like the vigour it has displayed during other periods of aggressive Fed tightening.

Second, core inflation is currently running at a little more than 2%, which we presume is close to the Fed's comfort zone.

Third, we are relatively optimistic that commodity price pressures – including oil prices – should begin to abate somewhat. Crude oil stocks are now ample and other commodity prices should respond soon to Fed tightening. China remains a wild card for commodity markets, but continues to impose credit controls and may have to consider more aggressive rate hikes as well.

Job Market Remains Tepid

Many market participants – and probably a number of Fed officials – believe that rates need to continue to rise substantially simply because they are still at historically low levels. The understandable fear is that unusually low rates encourage excessive risk taking and credit creation. That in turn can trigger not just inflationary pressure but also unwelcome boom/bust cycles in asset markets (like stocks and real estate).

Even though the Fed funds rate has risen from 1% in June 2004 to 2.75% currently, it still remains at the low end of its historical range and is quite low in inflation-adjusted terms. With core inflation running at around 2.3%, the real rate is still barely positive, compared with an historical average of around 1.5%. That is nirvana for borrowers and helps explain why real estate markets remain so bubbly.

U.S. Job Market Shows No Signs of Overheating Nonfarm Payrolls - Monthly Change (000s)

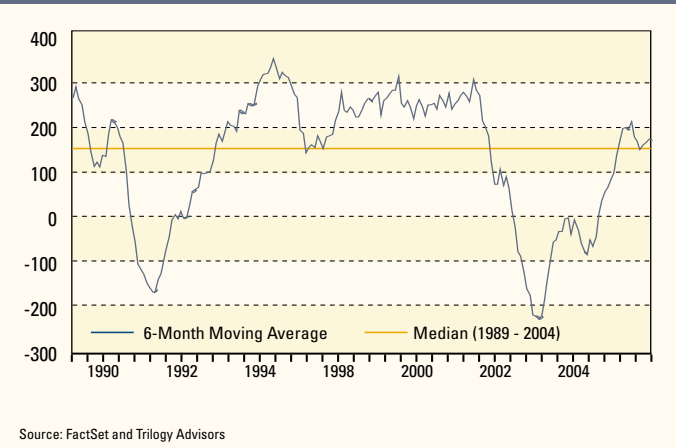


Chart 2: In the last six months, the U.S. has created an average of only 160,000 jobs per month. That is far less than in 1994 and 2000 when the Fed tightened aggressively.

But if monetary policy is too easy, why is the labour market so lacklustre? The U.S. economy produced only 110,000 new jobs in March and has posted average monthly job gains of about 175,000 over the last six months. While that is not bad, as we show in Chart 2, it is only slightly higher than the median monthly gain of 155,000 jobs posted over the last 15 years, during good times and bad.

Furthermore, recent job creation lags other periods of economic expansion when the Fed tightened aggressively. Consider the last two cycles of significant monetary tightening, in 1994 and 1999. In 1994, job growth averaged 320,000 per month, far above recent levels. Likewise, as the Fed raised rates in the last three quarters of 1999 and the first quarter of 2000, an average of 280,000 jobs were created per month, following many years of solid gains.

In contrast, today the U.S. is not looking back on many years of solid growth in employment. Due to the recession of 2001 and the subsequent weak labour market recovery, the U.S. has



created only 380,000 new jobs (net of job losses). However, over the same period, population growth has increased the size of the labour force by 4.5 million workers.

If anything, the current tone of the labour market is closer to what was seen in 1993 or 1995, when the Fed put monetary policy on hold for many months. Unless Fed officials see a dramatic pickup in the pace of job creation, they may soon question whether the Fed funds rates needs to continue its rise to the 4.0% level that the markets have already discounted.

Core Inflation – Anchors Away?

The recent rise in oil prices certainly has market participants and the Fed alike concerned about the possibility of high oil prices triggering more broad-based price pressures. Fed officials signalled this concern following the March 22 meeting of the Federal Open Market Committee (FOMC), when they made the following observation:

“Though longer-term inflation expectations remain well contained, pressures on inflation have picked up in recent months and pricing power is more evident. The rise in energy prices, however, has not notably fed through to core consumer prices.”

That relatively mild statement managed to unnerve both the stock and bond markets because it contrasted with previous FOMC pronouncements that characterized inflation expectations as “well anchored.”

A key inflation measure for the Fed is “core” inflation, which is the consumer price index excluding food and energy. (That, of course, matters to all of us who do not eat or drive cars.) The Fed cares about that measure because a rise in core inflation

would indicate whether commodity price shocks were feeding into more broad-based pricing pressures and inflationary psychology. Core inflation is now running at 2.3% per annum, which is identical to its median performance over the past decade.

We presume that Fed officials are reasonably comfortable with this rate of inflation for a simple reason: They were obviously uncomfortable with an inflation rate of 1.0% to 1.5% in late 2002 and early 2003. At that time, some Fed officials fretted openly about the risk of deflation and indicated that the Fed would move aggressively to prevent deflationary forces from taking hold.

So while we can assume that Fed officials do not want the rate of core inflation to accelerate from current levels, we also assume that they do not wish to tighten policy so aggressively that deflation becomes a risk again. And since the rate of inflation tends to be a lagging business cycle indicator, they are unlikely to be too concerned if more forward-looking indicators like the yield curve begin to look better.

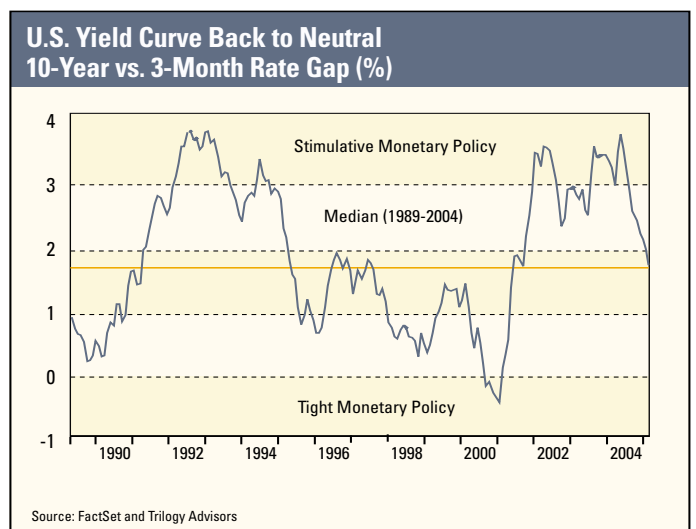


Chart 3: Judging from the gap between long- and short-term interest rates, Fed policy has already returned to a neutral position.



The Message from the Yield Curve

As shown in Chart 3, the yield curve has already moved from signalling that monetary policy was extraordinarily easy a year ago to a current “Goldilocks” configuration, which suggests that policy is neither too easy nor too tight. With the interest rate on three-month U.S. Treasury bills standing at 2.70% and 10-year government bond yields at 4.5%, the gap of 1.7% between short-term and long-term rates is very close to the 15-year average gap of 1.9%.

Historically when the yield curve has flattened – as it has in recent quarters – other indications of pricing pressure like metals prices and other commodity prices begin to roll over within several quarters as economic activity subsequently moderates. The key word here is “moderates,” not “plummets.” The current configuration of the yield curve is signalling continued growth ahead, albeit at a more moderate pace than last year.

Now if the Fed were to raise rates so aggressively that the yield curve moves to an “inverted” position (short-term rates are higher than long-term rates), historically that has been a good sign that monetary policy is so tight that a recession is on the horizon. Not surprisingly, stock markets have tended to do poorly as well during such periods. Major financial blowups tend to occur when the Fed is moving so aggressively as to invert – or come close to inverting – the yield curve. Examples include the U.S. savings and loan crisis in 1990, the Mexican crisis in 1993, and the Nasdaq slump in 2000.

With markets already pricing in a Federal funds rate of 4% by the end of the year, we assume that long-term rates will not move up that much if the Fed raises short rates by exactly that amount. Unless the Fed decides to take an extended break,

that means the yield curve could come close to inverting in the second half of the year – with all the nasty shocks that could bring along, including fears of recession for 2006.

If inflation accelerates markedly from current levels, the Fed could decide that is a risk worth taking. However, if commodity prices begin to ease and inflation remains in the Fed’s comfort zone, the case for an extended pause would strengthen. We are encouraged to see both crude oil inventories and gasoline inventories at the high end of their normal range. Notwithstanding the recent highly publicized forecasts that oil prices will soon reach \$100 a barrel, the inventory picture suggests to us that energy prices may be set to decline – for a while at least. Other leading indicators of commodity prices are also beginning to roll over.

Finally, it is worth remembering that by far the biggest driver of inflation is labour costs, not commodity costs. So as long as international competitive pressures help keep a lid on labour costs and job growth in the U.S., the odds are that overall inflation will remain “well contained,” to use the Fed’s phrase.

Our bottom line is that the markets are currently too pessimistic regarding the Fed’s likely course of action this year. If we are correct, and the Fed decides to take a break from tightening some time in the coming months, that should be “the pause that refreshes” from the point of view of global equity markets. If we are also correct that oil prices will stabilize or come down a bit, so much the better.

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