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ECONOMIC TALKING POINTS

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A Preponderance of Solid Reports Say the Economy Can Absorb Higher Rates

August's retail sales turned out to be the strongest of the year, and followed a hefty upward revision for July.

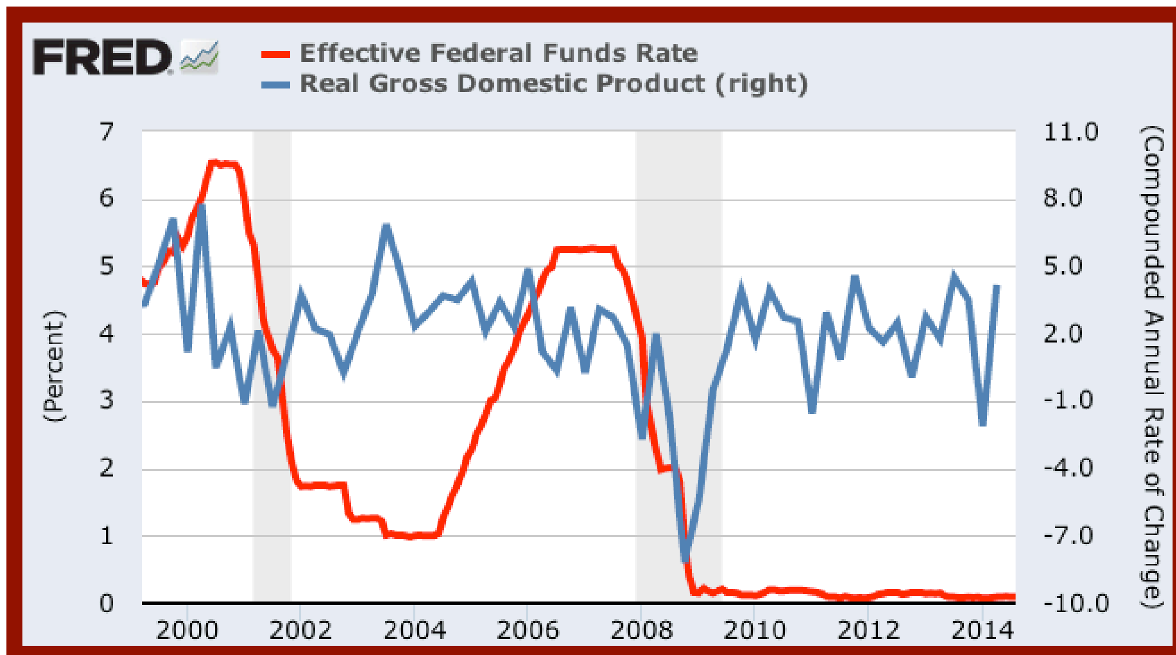
The 0.6% jump in sales last month was the biggest in four months, with higher spending by consumers in 11 of the 13 categories. One that slid was at gasoline stations, but that can be attributed to lower prices at the pump. July's preliminary flat retail sales, which lacked credibility from the start, turned out to show a rise of 0.3%.

In addition, we got news consumers are turning even more upbeat. The University of Michigan's mid-month September index on overall sentiment rose to 84.6 (compared to 82.5 at the end of August), the best reading in more than a year. Perhaps more relevant is that expectations of wage growth turned out to be the highest in 6 years! That should set the stage for even more household spending in the months ahead.

The latest set of positive reports shows the US economy continues to gain momentum and that the shadow of the last recession has now receded into history. The job market is improving, Americans are shopping, companies are ramping up capital expenditures, profit margins are the widest ever, exports are shattering records, and the stock market has been on a tear in recent months.

All of this increases the probability the FOMC will alter its guidance next week. Even though an actual increase in short-term rates is not imminent, investors in both the fixed income and equity markets are becoming more skittish as they anticipate the effects of higher borrowing costs next year. The Federal Reserve is certainly aware of such sensitivities**.** **FOMC members know they have the delicate task to craft new text that hints of a pending change in monetary policy, but with words that do not convulse the markets.**

Fed funds rate (Left axis), Quarterly Real GDP % (Right axis)



How to adroitly transition monetary policy from one that has been uniquely accommodative --- to a more restrictive stance, is where the Fed has frequently blundered in the past. Paul Volcker was absolutely right when he said the central bank's biggest mistake that led to high inflation in the past was not from being too loose, but rather waiting too long to tighten when times are good.

It is a difficult undertaking, to be sure. But the one theme that has emerged from all the economic indicators lately is this: **The six-year long emergency lifeline by the Fed to hold short-term rates near zero is no longer an appropriate policy. Indeed if left unchanged, the risk grows this unprecedented stimulus could fire up inflation.** Our view is that despite Janet Yellen's dovish reputation, she is not going to jeopardize the hard fought campaign by Volcker and Greenspan to bring down and keep in inflation low.

Quantitative easing is coming to an end this year, as it should. The time has also come for Fed policymakers to scrap its zero-bound strategy. Will this cause Treasury yields to drift higher? Yes, but they should still remain far below levels that would derail growth. The Bernanke-Yellen Fed has been far

more transparent with its forward guidance than any of their predecessors. As a result, there will not be a repeat of the policy shock that occurred in 1994, when Fed Chairman Alan Greenspan thunderstruck investors by abruptly jacking up rates, a move that massacred bond portfolios and ulcerated investors.

Indeed, demand for government debt will stay firm this time for several reasons, including an unstable geopolitical environment, relative strength of the dollar, and the need for financial institutions to meet higher capital and liquidity ratios. At the same time, the supply of new Treasury issuances will shrink due to the decline in the budget deficit.

Bottom line: The US economic recovery is now entering its sixth year and much credit for that goes to the Federal Reserve. The central bank has steered the nation through its gravest financial crisis since the 1930s, if not in history, by driving down the cost of borrowing to its lowest ever. We expect the Fed will now change course. **Investors and business leaders have to make the distinction between a return to the normalization of interest rates --- and the kind of monetary tightening that is designed to curb economic growth. The time has come for the former; the latter is still way, way off.**

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