Evidence of strong global economic growth has persisted in early 2006, the natural result of ample financial liquidity worldwide. The mobilization of supply from developing countries has held down core inflation in industrial countries, permitting central banks to remain accommodative. Strong economic growth has been reflected in strong commodity prices, rising stock prices and upward pressure on long-term bond yields in most major countries. The rise in bond yields has been due more to a rise in real yields (actual yields minus expected inflation) than to a rise in inflation expectations.

In the U.S., the basic theme for the last three years has been “successful reflation.” The economy has grown at a somewhat above-trend pace, the unemployment rate has dropped, profits have risen, and core inflation has remained low with the pass-through of higher energy prices to broader inflation quite limited so far.

From a worldwide perspective, macroeconomic policy has remained stimulative. China and other Asian countries retain a stimulative mix of low interest rates and low real exchange rates. Japan is on a path to its first tentative monetary tightening later this year. The European Central Bank has tightened slightly, but in a very gradual manner. In the U.S., there has been a larger shift in policy, with the Fed funds rate having risen 15 times from a hyperstimulative multi-decade low of 1% to 4.75% currently, with a 16th rise to 5% widely expected on May 10. However, the Fed appears to be approaching a pause, if not necessarily a cyclical peak, in its tightening.

Our view continues to be that (1) Fed rate rises represent a normalization of policy, (2) the Fed so far has not made a decision that restrictive monetary policy is necessary and is unlikely to make such a decision any time soon, (3) the housing sector will experience gradual and persistent weakness rather than a severe decline and (4) there should be a prolonged spillover effect of housing weakness on U.S. consumption but its severity should be limited by a strong labor market.

What’s the outlook for Fed policy? Four scenarios for future U.S. monetary policy are “pause and resume,” “long pause,” “straight up” and “cycle peak and early ease.” We believe that “pause and resume” or “long pause” are the most likely.

Two factors argue against a “straight up” scenario. First, while there are risks of future upward pressures on trend inflation, only limited evidence of such a development has emerged so far. Second, the minutes of the March 2006 Federal Open Market Committee reveal that “most members thought that the end of the tightening process was likely to be near.” This confirms that the Federal Reserve believes that it is in the late stages of a well-advertised normalization of interest rates and has not made a decision to move to restrictive policy. The Fed expects a moderation of economic growth and does not believe that inflation evidence released so far justifies such a restrictive policy. Given this mindset, we do not believe a “straight up” scenario is likely.

The “cycle peak and early ease” scenario is based on the thesis that the Fed has overtightened inadvertently in its attempt to normalize interest rates. Advocates of this view tend to believe that (1) financial liquidity has been significantly tightened by the Fed’s action, (2) the housing market will decline sharply rather than stall or weaken gradually, (3) weak housing prices will have a powerful negative impact on consumer spending and (4) the unemployment rate will quickly shift higher. We are skeptical about each one of these building blocks of the pessimistic case, at least for this year. The odds of subpar growth are higher for 2007, especially in the event of a “pause and resume” scenario.

MARKET COMMENTARY
Provided by Dreyfus Chief Economist, Chief Investment Strategist Richard Hoey
April 25, 2006
The “early ease” advocates see a rising risk of a hard landing for the economy. However, the Fed consensus seems to be for a successful soft landing. With the Fed likely to pause soon, hard landing or soft landing are not the only two economic scenarios. It is also possible that there could be a “fly-by” with little slowdown in underlying economic momentum. Because the reported growth rate in the early months of 2006 has been biased upward by the recovery from temporary weakness in late 2005, there should be a statistical slowdown in the U.S. economy from the first half to the second half of 2006. It is less clear that there will be a major deceleration in the underlying growth rate of the economy this year. Several years of easy monetary policy have left the economy with ample financial liquidity to fund continued expansion.

If “long pause” and “pause and resume” are the two most likely patterns, what will determine which one actually occurs? We believe that long-term inflation expectations and the Fed’s forecast for core inflation in 2007 will be most important. Well-anchored, long-term inflation expectations are a crucial measure of the Fed’s credibility. We would expect the Fed to be very responsive to any significant rise in long-term inflation expectations. We believe that Chairman Bernanke is more forecast-oriented than Chairman Greenspan was. He may eventually increase the frequency of the gathering and release of the Fed’s consensus economic forecast (now released twice a year).

The Fed is focused on the core PCE, an inflation measure that has run at a 1.8% rate in the last 12 months, below the core consumer price index at 2.1% and the overall Consumer Price Index at 3.4%. According to the March 2006 Fed minutes, “core PCE inflation was expected to move slightly higher in 2006…and to step back down in 2007.” Once the Fed pauses, shifts in its forecasts of core inflation in 2007 should become critical. The Fed can stand pat as long as it continues to expect core inflation to “step back down in 2007.” If resource utilization remains tight in an expanding economy, the Fed may reach the conclusion that core inflation may not decelerate in 2007 and therefore choose to resume its tightening later in 2006.

Mr. Hoey’s comments are provided as a general market overview and should not be considered investment advice or predictive of any future market performance.

Mr. Hoey’s views are current as of the date of this communication and are subject to change rapidly as economic and market conditions dictate. Contact Dreyfus or your advisor for current information about Mr. Hoey’s views of the economy and the markets.