TrendMacrolytics

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FED SHADOW

How Much Room?

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How much longer will the Fed be able to court inflation risk as it fights a non-existent deflation?

Alan Greenspan's comments last week all but pledging to sanction another rate cut have not only removed any market uncertainty over whether a 25 basis point lowering of the funds rate target will be forthcoming from **Fed** policy makers in two weeks. Interest rate futures are now pricing for growing odds that our monetary masters will emerge from the June 25 session having slashed the overnight rate by 50 bps, to a subterranean 0.75%. And with credit market participants content, for now, to overlook any potential inflationary consequence of the Fed's largesse, long-maturity Treasuries have hitched a profitable ride on the Fed-expectations bandwagon.

The better-than 20 basis-point decline in the 10-year note yield since last Monday to a 45-year low below 3.20% has closely corresponded with betting in the July fed funds futures contract on the target likely to be set by the **FOMC** in two weeks. Just prior to Greenspan's speech, the contract was priced for a 60% chance of a quarter-point cut. Today, the contract is fully discounting for a 25 bp cut to 1%, and a 70% chance for a 50 bp cut.

This suggests that long-dated Treasuries could have some further short-run upside if the futures continue to up the odds on a full 50 bp cut and the Fed confirms it. Indeed, given the extent to which Greenspan and his central bank colleagues appear to be aiming at lower long-term rates as a policy objective, it's a good bet they would not want to risk a back-up in yields by disappointing market expectations. Continued movement of the benchmark Treasury toward an unheard-of yield of 3% seems entirely plausible at this point.

From a longer-term perspective, however, the current one-way bet in Treasuries appears to be leaving them increasingly vulnerable. Most important, the nation's creditors could come to rue the extent to which they have accepted Greenspan explicitly tossing aside any hint of concern about the inflationary risks of the Fed's current mission to forestall what are now non-existent deflationary impulses. "We have concluded … inflation was not something of significance for the Federal Reserve to be concerned about," Greenspan said in his speech last week, in what could end up standing as one of the Fed chairman's most remarkable statements. "The reason why you are hearing a good deal about the deflation issue is that we perceive that as a low probability … but the cost of addressing it is very small indeed."

We have warned since late last year that the same inherently flawed demand-based policy framework which compelled the central bank to embark on its ruinous deflationary course in the late 1990s also could also set the stage for an inflationary overshoot (see "A Deflation Dichotomy" November 18, 2002.) The recurring tendency of the Fed to "fight the last war" stems from its "output gap" approach, under which it seeks to manage real economic variables rather than stabilize the purchasing power of the currency, the only task for which it is suited by the operating levers of policy. In the final years of the last decade, the Fed engineered a deflationary dearth of liquidity based on the mistaken notion that the robust pace of expansion spelled inflationary danger. The risk now is that it will foster an inflationary dollar glut acting in equally fallacious trepidation that current economic sluggishness poses the risk of deflation. The irony, of course, is that the lackluster pace of recovery that the economy has witnessed thus far essentially reflects the lingering after-effects of the Fed's deflationary error, which crushed the market's capacity to put capital at risk. In important respects, those risk-taking instincts now appear to be on the mend. An inflationary error by the Fed, however, would likely deal a new setback to recovery of the capital formation process.

We take some comfort from the fact that the most sensitive gauges of the unit of account have been well-behaved during this period. In fact, the dollar has appreciated modestly against gold and stabilized against foreign exchange in the past week at levels showing no signs that an inflationary liquidity excess is in the offing. It could be that the enactment last month of a strongly pro-growth tax cut will turn out to be a doubly fortuitous event, increasing the demand for dollars enough to give the Fed room to engage this deflation distraction without inflationary consequences. How much room, however, will be a relevant question for the foreseeable future. TM