

FED SHADOW

## Is This What They Had In Mind?

Monday, August 18, 2003

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**The Fed has allowed long-submerged inflation risks to resurface, but appears unlikely to allow the risk to become reality.**

Less than a week removed from their policy-setting session that produced the seemingly reassuring statement that **the Fed's** accommodative stance "can be maintained for a considerable period," our central bankers must be wondering where they went wrong. While backing off its intra-day highs above 4.6% seen prior to the blackout Thursday, at around 4.5% the 10-year Treasury has climbed some 15 basis points from its pre-FOMC close last Monday. While the short end of the curve initially rallied on last Tuesday's announcement, the two-year note has reversed those gains, and at about 1.85% the yield is back near its bear market highs of two weeks ago.

In the interest rate futures markets, meanwhile, the odds-on bet for rate hikes beginning next spring, which at first slipped immediately following the meeting, has been restored. The April fed funds contract, in fact, is now priced for a 25 bp increase in the 1% rate target, while Eurodollar futures are discounting for 75 bp in rate hikes by next June.

How could policymakers' obvious attempt to placate a battered credit market be going so badly? After being hammered for knee-capping a market that bought into the Fed's misplaced deflation warnings of May and June, Fed officials no doubt believed their latest message would have a soothing effect. But by essentially pledging to maintain its easy money posture in the face of clear signs that the need for such exceptional monetary accommodation was over, the Fed is now managing to rekindle long-subdued inflation risks. At the same time, it should be kept in mind that these risks are rising from historically low levels, and at this point do not appear to foreshadow a real inflation threat.

Still, the signs of increased risk are difficult to miss. With inflation risk in bonds magnified by the length of the term, underperformance of long maturities relative to short is one telltale sign of potential inflation risk. Since last Monday, the 10/2 yield curve has steepened by nearly 15 bps, and at about 270 bps is now some 65 bps steeper than it was at June's market top. The short end of the curve has also sold off because the rise in inflation risk reinforces expectations of an approaching Fed policy shift to raise the rates to which short-maturity bonds are most sensitive.

**10-year/2-year Treasury Yield Curve**



As much as the rise in yields, the heightened volatility in longer maturity issues the past several days can also be seen as reflecting the reappearance of inflation risk, as the market's confidence in its estimate of future inflation becomes subject to increased uncertainty.

The central bank virtually invited this skeptical market response with its assertion Tuesday that the risk of "an unwelcome fall in inflation exceeds that of a rise in inflation." With the dollar's reflation over the past 18 to 20 months by 20% to 30% in terms of foreign exchange, gold and other sensitive commodities, such a statement can only raise questions about the Fed's commitment to maintain the purchasing power of the unit of account. Indeed, it takes no great leap of logic to suggest that if the Fed deems a core inflation rate now running slightly above 1% dangerously *low*, more inflation must be what it wants.

In fact, though, we're inclined to give the Fed somewhat of the benefit of the doubt on this score. While its maladroit wording can certainly cause confusion, the Fed's real aim is to avoid a further significant fall in reported inflation, not to encourage its rise. As we have suggested, the dollar's softening seen to date basically ensures that the period of falling inflation rates -- or "disinflation" in the economics lexicon -- has passed (see ["FOMC Preview"](#) August 11, 2003.) And while that might mean some rise in the distorted, lagging statistical inflation indicators, it would not necessarily imply a further decline in the dollar's true value.

The fall in the reported inflation rate from about 2.5% to less 1% over the last few years was a delayed response to the dollar's deflation dating back to the late 1990s. So too, the incremental rise in the indexes now being seen (the core PCE deflator is now running at an annual rate of about 1.15%, versus less than 0.8% earlier this year) primarily reflects the subsidence of downward price pressures brought about by the end of deflation. Any suggestion, therefore, that an accelerated inflationary breakout now lies in store seems highly premature. The price of gold shows little inclination to break out of trading ranges around \$350 to \$360 per ounce, and the dollar's forex value has recently displayed a modest tilt toward strength. Moreover, some two-thirds of the 140 bp yield jump since the market's June top can be explained by a rise in real yields, as seen in TIPS yields rising from 1.4% to about 2.35%. While that still has resulted in an increase of some 45 bps in the inflation expectations gap between nominal yields and their inflation-protected counterparts, that leaves the TIPS spread -- at a little over 200 bps -- within the range it has held during the past several years of low-inflation experience.

More than anything, we expect that this post-FOMC bond market agitation will serve as a wakeup call to policy makers, instructing them that while the bond market might not welcome higher rates, it abhors anything that hints of higher inflation. We expect that by no later than the October meeting (the next FOMC session is scheduled for September 16), the Fed will have jettisoned its expressions of concern about "undesirably low" inflation, setting the stage for a rate-hiking cycle beginning perhaps by the end of the year. Even so, we don't look for a more attentive Fed to be of much comfort to bonds for long. While their rise over the past couple months is consistent with an improving pace of economic performance, real yields remain at levels that do not yet appear to be discounting for the growth acceleration that we expect -- most likely in excess of 4% for this year's second half alone. Even allowing for the fact that a slow-to-respond Fed is likely to keep a damper on real yields, a TIPS yield of less than 3% is unlikely to be sustained long term. That also implies the days of the 10-year Treasury yielding less than 5% are likely to be numbered. **TM**