TrendMacrolytics

Donald Luskin, Chief Investment Officer
David Gitlitz, Chief Economist
Thomas Demas, Managing Director

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Back from the Inflationary Brink

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David Gitlitz

Evidence of jobs recovery may save the Fed from an all-too-familiar policy error.

Last Thursday we warned that first signs of turnaround in the jobs data would likely be the occasion for yet another shift in the manic-depressive **Fed** expectations environment, triggering an abrupt reversal in significantly overbought Treasuries (see "Treasuries: Face the Inevitable" October 2, 2003). This was amply borne out Friday by the jump of almost 20 bps in the 10-year note yield to about 4.2% in response to the payroll gains seen in Friday's employment report.

As forecasters, we were gratified by Friday's Treasury move. But the nearly $14 plunge in the price of gold, which put it below $370 for the first time since late August, may have been the single most welcome market reaction to the employment report. We have warned for the past month that the Fed's single-focus preoccupation with labor market stagnation amounted to a dangerous adventure on the brink of igniting an inflationary outbreak, signaled by gold flirting with ten-year highs at $400. Recent currency instability, which could reduce dollar demand, has threatened to push the Fed over the brink. Gold's decline on Friday offers solid affirmation that the reported job growth goes a considerable way toward allaying that risk.

With Friday's evidence of a labor market recovery potentially moving the Fed off its indefinitely-on-hold position, Treasuries remain vulnerable to a correction that could see them quickly test the levels of early last month, around 4.5% to 4.6% on the 10-year. The Treasury action Friday corresponded with the Eurodollar futures market moving to price for an 80% chance of 50 bps in rate hikes by next June, after closing the previous day discounting for less than a 90% chance of even a 25 bp hike. At the same time, through, Treasuries have ducked a bullet. Now the risk of a sudden impounding of inflationary expectations has been significantly lessened.

These market developments surrounding release of the September jobs data, by the way, once again expose the deeply flawed conventions guiding Fed policy, as well as the bulk of orthodox economic opinion regarding monetary policy and inflation. In the face of repeated Fed warnings that slack labor market conditions represented a threat of further "disinflation," the most sensitive market indicators of dollar purchasing power -- including gold and foreign exchange -- have been reflecting exactly the opposite risk: inflation. Such rhetoric only raised the specter of the Fed attempting to use monetary means (additions to dollar liquidity) to solve non-monetary problems (a static job market) -- throughout Fed history, such interventions have always resulted in substantial inflationary error. With the first signs of healthy job growth in the past eight months, hopefully the Fed will move on now to some more benign obsession.

As for the jobs data, we are most encouraged by the gain of 33,000 temporary workers on private payrolls, the fifth straight monthly gain. Increased hiring of temporary help has proven to be a reliable leading indicator of hiring upturns, and this time around is likely to prove no exception. Over the past six months, 142,000 temporary workers have been added to payrolls. TM

http://www.trendmacro.com
don@trendmacro.com
dgitlitz@trendmacro.com
tdemas@trendmacro.com

Offices:	Phone:
Menlo Park CA	650 429 2112
Parsippany NJ	973 335 5079
Stamford CT	203 322 1924