TrendMacrolytics

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FED SHADOW

Saddam's Not Enough

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Geopolitical/military risk is one thing -- and monetary risk is another.

Today's non-response by the most sensitive market price indicators to news of **Saddam Hussein's** capture amounts to another compelling piece of evidence that **the Fed** is falling further behind the inflation curve. While the erosion of dollar purchasing power reflected in gold and foreign exchange is primarily indicative of an overly easy Fed posture, it's not implausible to suggest that some element of the weakness reflected demand for safe-haven assets owing to the geopolitical/military risk environment. It's clear, though, that whatever mitigating impact Saddam's apprehension might have had on the safe-haven trade, the boost to dollar demand was not enough to offset the dollar-depressing effects of the Fed's hyper-accommodative stance. After initially selling-off by some $6 in overnight trading, gold retraced its decline through the New York session, and by mid-afternoon was unchanged on the day at about $409. Similarly, in the forex markets, a modest early dollar rally gave way to another decline of the greenback against most major currencies.

This comes after a week in which the central bank seemed nearly to invite speculation that it is perfectly content to see a continued downtrend in the dollar's real buying power. In the statement following Tuesday's **FOMC** meeting, the Fed took a small step toward an eventual shift in its policy stance, downgrading disinflation risk so it is now "almost" equal to that of a rise in inflation. Clearly, though, policymakers are in no hurry to confirm their shift in perspective with a tightening move. Citing "quite low" inflation and "slack" resource use, the committee repeated the mantra that "policy accommodation can be maintained for a considerable period." In essence, the Fed acknowledged that it sees a higher risk of inflation than it had previously, but is not yet prepared to do anything about it.

The extent to which the Fed is again being led astray by backward-looking macro indicators became even more apparent with release Thursday of the October FOMC minutes. The committee said it anticipated that "economic performance in line with…expectations would not entirely eliminate currently large margins of unemployed labor and other resources until perhaps the latter part of 2005 or even later. Accordingly…significant inflationary pressures were not seen as likely." The panel also satisfied itself that the "degree of slack in resources and a rate of inflaition that was essentially consistent with price stability suggested that the Committee could wait for more definitive signs that economic expansion would otherwise generate inflationary pressures before making a significant adjustment to its policy stance."

This is, of course, the same mistake committed by the Fed in 1999-2000, only in reverse. At that time, the monetary masters were convinced that tight resources and a "dwindling pool of available workers" translated into a risk of sharply higher inflation. The historic bear market and recession of 2001-2002 were the direct result of the Fed's calamitous deflation error. As the Fed went to some lengths last week to maintain a sanguine face to the world, the markets saw a clear signal of rising inflation risk, sending the gold price higher, the dollar lower, TIPS spreads

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wider, and the yield curve steeper. At this point, we see no reason not to expect continued movements in the same direction until the Fed signals that it is coming to terms with the reality it faces. TM