TrendMacrolytics

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FED SHADOW

Clear and Present

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Everyone seems to know the Fed is raising rates. But does the Fed?

There should be little surprise that today's marginally disappointing reading on first quarter GDP hardly altered expectations for a marked shift in **Fed** policy in the months ahead. Certainly, one cannot entirely rule out the possibility that a complacent Fed could take cover in a slightly less robust number, given its recent track record devising misguided excuses to delay the inevitable. But the market now has to assume that the Fed will only be so "patient" in standing idly by as the consequences of remaining too easy for too long become increasingly apparent.

Indeed, the key factor holding reported real growth to an annual rate of 4.2%, versus the consensus estimate of 5%, was the similarly unexpected uptick in the inflation component of GDP. While nominal growth of 6.8% was broadly in line with expectations, the shortfall in real output reflects that the overall rate of expansion was accounted for by inflation to a significantly greater extent than was anticipated -- 2.5%, as opposed to expectations of less than 2%. Even more troubling than this absolute rate of change in the implicit price deflator -- though hardly surprising to us -- was the acceleration represented by the jump from 1.5% in last year's fourth quarter, and 1.7% for all of 2003.

The standard analysis usually views the Fed expectations environment as being a function of the Fed's signals to the market, but in this instance the lines of communication are running in the opposite direction, and we can only hope that the central bank is listening. It was striking to us that after a parade of Fed officials spent last week attempting to mollify markets made jumpy by the near-term prospect of rising short-term rates, the most sensitive readings of short-rate expectations were not to be placated. Against the familiar prattle of super-dove **Ben Bernanke**, the supposedly calming tones of **Alan Greenspan** and the soothing voices of various other central bank figures, the futures markets went about their business pricing in an altered policy environment. A month ago, December fed funds futures were priced for less than a full 25 basis point move. The contract is now fully discounting 75 bps in rate hikes and moving toward 100. Since early last week the futures market has tacked on more than 20 bps to the expected year-end overnight rate. In the face of Fed officials' repeated insistence that "slack" resource use, lingering labor market uncertainties and strong productivity growth continue to subdue inflation pressures, the market's message to the Fed is that the case for keeping funds at a 46-year low of 1% has evaporated.

Whether the Fed is getting the message should become more clear with next Tuesday's post-**FOMC** statement. If policy makers are prepared to set the stage to begin hiking rates this summer, the release will be substantially rewritten. Gone will be the assertion that upside and downside risks to continued expansion are "roughly equal," that the probability of further disinflation outweighs the risk of a rise in inflation, and that "new hiring has lagged." Policy makers could also remove all these references but continue to signal that they are keeping their options open by repeating the assurance that the panel "believes that it can be patient in removing its policy accommodation." If that phrase is removed and not replaced by similar language, the odds-on bet for a first rate hike will be moved forward from August to the next meeting in late June.

To be sure, an earlier rather than later move into rate-hiking mode will offer a degree of confidence that a damaging inflation breakout can be avoided. Any assurances in that regard, however, would yet be premature. Due to the rigidities of its rate-targeting procedures, the early stages of Fed policy change can yield perverse results. For example, after rate cuts began in early 2001, a full year passed before any evidence of an easier monetary environment surfaced in indicators such as the gold price or the dollar's forex value. In that economic and financial downdraft the funds rate remained above the economy-wide rate of return for many months, keeping policy tight even in the midst of a seemingly aggressive rate-cutting program. In the context of the robust returns currently available to productive economic endeavor, policy figures to remain highly accommodative for quite some time despite what might appear to be significant tightening steps. By the time the methodical, drawn-out process of bringing the funds rate up to an equilibrium level of at least 3 to 3.5% fully evolves, additional inflationary impulses could well become embedded in the system.

The behavior of the price of gold over the last several sessions can be seen as reflecting the continuing risk in the inflation outlook. When gold fell from the $425 levels of early this month in accord with the onset of rate-hike expectations, it was clear that the odds of a worst-case scenario were significantly reduced. Beyond that, though, significant uncertainty remains. Over the past week, the price has ranged in highly volatile fashion from just below $400 to just above $375. In the past 24 hours alone, spot gold first traced a downward path from $385 to $376, before turning around and bouncing back to $388 in late trading. Such heightened volatility is a reflection of the market's lack of confidence over what can be considered the "right" price, and -- by extension -- the right forecast for the future price level. TM