TrendMacrolytics

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FED SHADOW

Surprises in Store

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"Gradualism" means the Fed is not so gradually falling behind the inflationary curve.

Over the past eight weeks, **the Fed** has moved haltingly to catch up with the market consensus that the case for maintaining an excessively easy 1% overnight rate target has collapsed. Recall that even in the wake of the expectations-shattering employment and inflation data in April -- which first moved forward the market's rate-hike bet -- central bank officials clearly caught off guard were out in force attempting to play down the notion that early action was assured. Now, having acknowledged that its hyper-accommodative posture is no longer appropriate, the Fed appears on course to contend with yet another surprise, one that ultimately is likely to upset its current plans to pursue a "measured" approach to policy normalization.

A foreshadowing of that eventual encounter with reality has come over the past week in gold and foreign exchange trading, the market segments most sensitive to the likely impact of Fed policy on the value of the unit of account. These market price indicators had moved in accord with the expectations shift starting in early April, which allayed the most acute inflationary risks arising from a sustained open-spigot liquidity stance. This was captured most vividly in the gold price falling from $430 to a range around $390 heading into the May 4 **FOMC** meeting. When that meeting confirmed that the Fed indeed "believes that policy accommodation can be removed," although at a "pace that is likely to be measured," gold fell again, trading in a range around $375 for the first time since last fall. Over this early-April to mid-May timeframe, the dollar's trade-weighted forex value against its G-6 counterparts rose by some 5.5%.

But for some, the dollar's firming trend was taken as proof of independently diminishing inflation risks, and a sign the Fed might need to do less to achieve policy "neutrality." We saw this supposition as blind to actual cause and effect, and with gold again trading around $395, it's clear that the currency's strength is most directly responding to shifting probabilities concerning whether the Fed will tighten enough, soon enough, to quell an incipient inflation breakout.

Whatever confidence may have been developing in that regard took a significant hit with the comments last week of dovish **Fed Governor Ben Bernanke**, who suggested that a "gradual adjustment of policy" could be pursued because core inflation was likely to remain "in the zone of price stability." In a lengthy dissertation on the merits of "gradualism," Bernanke cited the usual litany of factors he sees likely to keep inflation at bay, including slack resource use, moderate wage pressures, rapid productivity growth and intense global competition. But while acknowledging the recent "flare-up in inflation" as a concern that "bears close watching," he did not relate how such an uptick -- with core CPI rising at a 3.3% annual rate over the past three months, up abruptly from a three-month annualized rate of 0.8% in January -- could be consistent with his recitation of the forces subduing inflationary pressures.

Probably most damaging is Bernanke's contention that a "significant portion" of the tightening adjustment "may already be behind us" due to the bond market's pricing for expectations of

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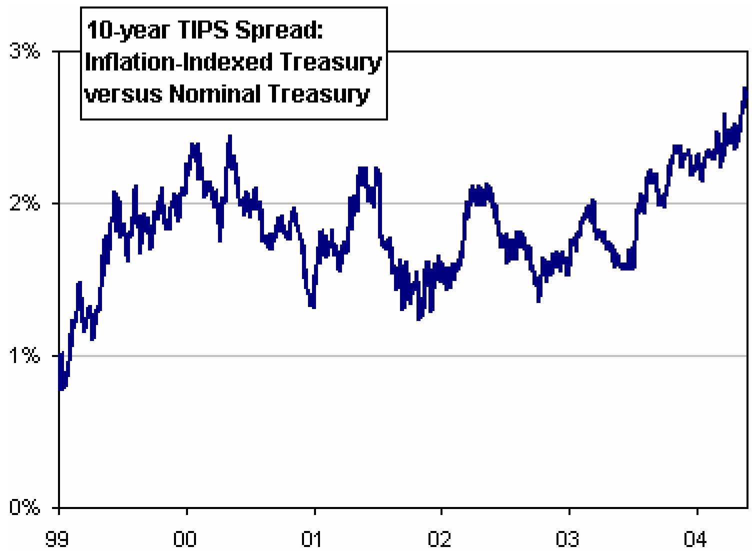
rising rates. "Broad monetary conditions have already begun to normalize," Bernanke said, "a development that should tend to limit future inflation risks." This is a dangerous delusion, rooted in rigid neo-**Keynesian** precepts that the function of monetary policy is to regulate aggregate demand, and therefore market yields rising in anticipation of a higher policy rate have essentially the same impact as an actual rate hike.

But as we have pointed out before, maintaining a steady funds rate in a rising market rate environment puts increased upward pressure on the funds rate, requiring larger liquidity additions to keep the rate at target. Thus, quite the contrary to Bernanke's belief, the Fed maintaining a lagging funds rate target is effectively introducing greater -- not lesser -- inflation impulses



The notion that rising bond yields have somehow been associated with tighter monetary conditions and falling inflation expectations is belied by indicators such as the spread between nominal Treasuries and their inflation-indexed counterparts (TIPS). Since April 1, as the benchmark 10-year Treasury yield has risen by 70 basis points, the 10-year TIPS spread has jumped by about 25 bp. More than a third of the rise in yields, in other words, can be explained by increased inflation risk. At nearly 270 bps, the TIPS spread is now at its highest level since shortly after the inflation-protected bonds were first introduced in 1997, and has risen by some 100 bps in the past year.

It's difficult to find fault with the **Dow Jones** wire report on Bernanke's remarks that portrayed him as "implying the Fed may not need to raise rates sharply or soon." Unfortunately, the former **Princeton** economics professor has emerged as an anchor of the Fed's intellectual consensus and can hardly be cast as a lone voice among policymakers. No doubt, the pop in gold and decline in the dollar since Bernanke's speech have aroused little if any notice among the monetary brethren. What it tells us, though, is that as leisurely as it might want to be in restoring some semblance of liquidity balance, the central bank has gotten seriously behind the curve. Taking the least forceful approach possible in the near term will only increase the odds of considerably more extensive and aggressive action later when the inflationary consequences of remaining too easy for too long become too obvious to ignore.

Almost assuredly, that will come as a rude surprise to policymakers whose adherence to backward-looking policy guideposts inevitably leads to such awkward reckonings. Our analysis points to the inevitability of a core inflation rate of at least 3% when all is said and done. At this point, the Fed can do virtually nothing to prevent that eventuality. It can either act to ensure that it turns out to be a brief spurt, or see to it that such a relatively moderate rate of price level acceleration is only the beginning of a damaging inflationary episode. TM