

FED SHADOW

FOMC Preview

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Gold tells the tale the Fed would rather be left unsaid.

On May 11, with the price of gold near the nadir of a six-week descent from \$430 per ounce to \$375, we advised against interpreting the decline as reflecting an appreciable quelling of incipient inflation pressures. Rather, we saw the gold market as still in the speculative backwash of the acceleration in **the Fed's** expected timetable to start normalizing its hyper-accommodative stance. The consequent liquidation of leveraged long positions represented only a pull-back from a worst-case inflation bet, we suggested, seeing "upside risk in gold as the market sorts through the developing monetary policy environment" (see ["What's Up With Gold?"](#) May 11, 2004).

Today, two days before the Fed is universally expected to sanction the first of those normalization moves, gold is again fluttering above the \$400 plateau in the clearest expression yet of the market's skepticism about the central bank's plans for a "measured" and "gradual" approach to this rate-hiking exercise. **Alan Greenspan** and his **FOMC** brethren may be content to focus on distractions such as labor market slack and spare industrial capacity in assuring themselves that the risk of a significant inflation uptick remains remote. But as the market price providing the most direct reading on the supply-demand balance for dollar liquidity, gold reveals the risks to dollar purchasing power posed by a Fed that apparently attaches no sense of urgency to the task of tightening its surplus liquidity posture. Indeed at \$400, gold is now trading more than 20% above its 10-year moving average, a gap which also foreshadowed the last inflation breakout in the late 1980s.

Fact is, the consequences of the Fed having stayed too easy for too long are increasingly being confirmed even in the backward-looking, badly lagging inflation indexes produced by the federal statistics bureaucracy. Today's release of the core personal consumption expenditures deflator shows the Fed's favored price measure rising at a three-month annualized rate of 2.5%. For sure, such a pace of price level growth is hardly alarming in an absolute sense. The troublesome issue, however, is not the absolute rate of change but the trend shift in the rate of change witnessed over the last several months. The three-month annualized rate bottomed at 0.4% last September, and was still a relatively quiescent 1.9% as of January.

Treasuries tumbled in the wake of the report, the 10-year falling three quarters of a point, lifting the yield some 10 basis points to 4.74%, while the two-year yield jumped 13 bps to 2.86%. The curve flattening on the news suggests the market believes the data could prompt the Fed to adopt a more aggressive posture in the all-important wording of the post-FOMC statement Wednesday. We'd welcome such a development, but consider it unlikely. For now, policymakers will remain loath to acknowledge the inflationary impulses they've allowed to take root for fear of the bond market carnage it would unleash. Unfortunately for the nation's creditors, however, such holding action is only likely to delay the inevitable. And in the final analysis, the longer the Fed waits to acknowledge reality, the worse it will be -- both for inflation and for bonds. **TM**