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

TRENDMACRO LIVE!

On June CPI

Friday, June 16, 2004

David Gitlitz

If today's inflation reading is as harmless as it looks, why did the dollar fall to multi-month lows on forex markets and gold pop to a range around $407, challenging its highest levels since mid-April? For one thing, the deceleration of core CPI -- with a reported rise of just 0.1% in June, down from 0.2% the previous month -- appears largely to be a statistical artifact. The **BLS** release says that a smaller increase in shelter costs was largely responsible for the slowdown, particularly a 0.9% drop in lodging away from home. Without seasonal adjustment, however, "the index for lodging away from home rose 0.7%," the BLS said.

But the market's interpretation of what the news means for **the Fed's** approach to policy normalization is even more significant than the statistical detail itself. After all, with a data aggregate as massive as the CPI, methodological distortions of one sort or another are pretty much a constant. The relevant issue is how the data impact policy, and whether the statistical flaws are likely to exacerbate the potential for policy error. With Treasuries rallying by up to 10 basis points across the yield curve and interest-rate futures pricing for an even more "measured" Fed stance, it's clear that today's CPI moves the risk of inflationary monetary error at least another notch higher. And when the inflationary day of reckoning comes for bonds, their fall will be just that much greater.

Bear in mind that even with the reported slowdown last month, core CPI is rising at an annual rate of 2.6% this year, versus 1.1% for all of last year. Moreover, as we've noted previously, using such backward-looking data as a guide to current policy is a sure recipe for policy blunder due to the lags involved. Today's reported inflation is a reflection of policy of no less than one year ago, and the *current* policy stance will continue to be reflected in inflation for at least the next year. One would hope that Fed officials are as cognizant of this reality as anyone, and will shape policy accordingly. Over the years, however, this Fed has repeatedly demonstrated that making assumptions about the soundness of its policy judgments can be a high risk proposition. TM