TrendMacrolytics

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

MACROCOSM

# Inflation: That '70s Show?

Monday, August 2, 2004

**David Gitlitz**

**The Fed now has several new reasons to make old inflationary mistakes.**

While today's **ISM** survey portrays a manufacturing sector that remains in robust expansion mode, it has not overcome the impression left by Friday's marginally weaker-than-expected reading on second quarter GDP regarding the policy transition now underway at **the Fed**. The market's bet, with bond yields down by some 10 to 12 basis points across the yield curve since Friday's advance GDP release and the 10-year back below 4.5%, is that the reported 3% growth rate will play to the Fed's bias to maintain a laid-back approach to the policy normalization process. That's also the message of the gold price, with the $5 pop back above $390 again conveying the market's skepticism about whether the Fed's exercise in measured gradualism will be adequate to the task of curbing incipient inflationary impulses.

For all the attention devoted to the reported second-quarter slowdown in consumer spending, it would be a mistake to overlook the increasingly apparent swing in inflation trends also captured in the data. The chain-weighted "core" GDP price deflator, for example, rose at an annual rate of 2.6% in the most recent three-month period, increasing for the fourth consecutive quarter, after bottoming at 0.8% in the '03 second quarter. Much of the media chose to ignore this data point in favor of emphasizing the "tame" rise in the core personal consumption expenditures deflator, noting that, at 1.8%, **Alan Greenspan's** favorite price indicator came in below the 2% rate considered the top end of the Fed chief's comfort range. Again, though, our concern is less with the absolute rate of change than with the trend shift in the rate of change. At this point, the core PCE is rising at a rate double its year-earlier pace.

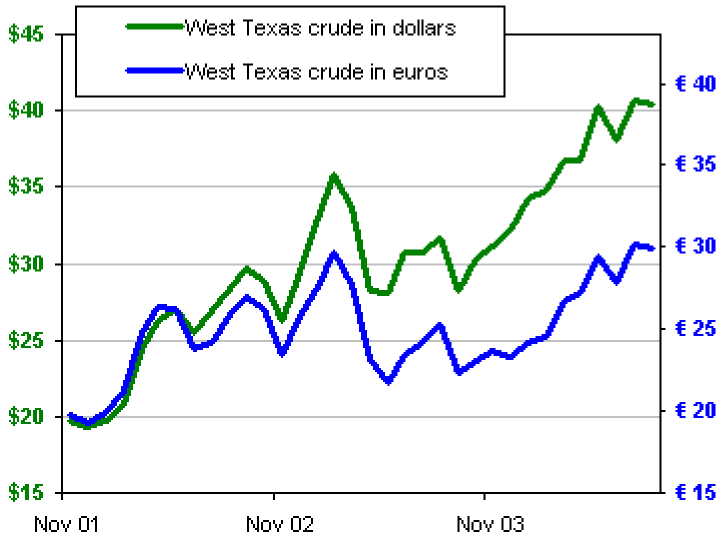
As we have discussed, monetary policy affects inflation with lags ranging from at least a year to as much two years, and at times even more. In the language of economics, the lags are referred to as "long and variable." That means the inflation now surfacing in the statistical indexes reflects policy of no less than a year ago, when the Fed was still in the early stages of its campaign to root out nonexistent deflationary influences by targeting an ultra-accommodative overnight rate of 1%. It's entirely possible, however, that the current inflation data is a reflection of policy going back to the second half of 2002, which is when we saw convincing evidence in market prices indicating that the central bank was finally overcoming its calamitous deflationary error. At that time, fed funds were being targeted at 1.75%. In other words, the still-mild core inflation currently registering in the data could well be traceable to the policy stance in place even before the final 75 bps in rate cuts were ratified.

In any case, if the core PCE deflator has doubled in the past year, it's hardly implausible to think that another doubling could be in store in the next year given the policy backdrop. And the fact is there's virtually nothing the Fed can do to prevent the effects of its excess liquidity posture from continuing to feed through the price system. The best the Fed can hope to do at this point is restore its target rate to equilibrium before additional inflationary influences become embedded.

http://www.trendmacro.com
don@trendmacro.com
dgitlitz@trendmacro.com
tdemas@trendmacro.com

Offices:
Menlo Park CA
Parsippany NJ
Charlotte NC

Phone:
650 429 2112
973 335 5079
704 544 6900




That task could be further complicated by the confusion being sown by the effects of rising oil prices. A significant portion of the slowdown in real consumption in the second quarter was attributable to higher energy prices. Nominal personal consumption expenditures rose by 4.3%, but due to rising oil prices the overall PCE deflator rose by 3.3%, leaving 1% growth in "real" consumption expenditures. A significant strain of sentiment in the conventional economic wisdom suggests the Fed must take account of this consumption drag, refraining from establishing a neutral policy stance as rapidly as it otherwise might. What this analysis overlooks, however, is the degree to which oil prices already reflect the dollar inflation imparted by the Fed's ultra-easy posture. As shown in the chart above, the oil price increase has been much more pronounced in dollars than it has in euros. The differential can be seen as one measure of the loss of dollar purchasing power attributable to the Fed remaining too easy for too long. Were the Fed now to accommodate the rising energy prices which stemmed to significant extent from its own policy error, it would risk repeating the disastrous course of the 1970s, one of the darkest chapters in its history. We'd like to believe that Greenspan & Co. know better than to intentionally court that risk. However we cannot rule out the possibility that sticking to a gradualist approach in this environment could end up having much the same effect. TM