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Reality Check

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As the evidence mounts, inflationary risks are becoming impossible for the Fed -- or the bond market -- to deny.

One month's data does not a trend make, but today's 0.3% jump in the core personal consumption expenditures deflator has to be raising some eyebrows at **the Fed** and has even registered with the "don't worry, be happy" credit market herd. The core PCE, known far and wide as **Alan Greenspan's** preferred inflation indicator, has risen just 1.6% year-on-year, which in the Fed's parlance counts as "well contained." Within that seemingly innocuous broad view, however, there are clear signs of a more disquieting directional shift. As we have noted in discussing recent behavior of core CPI, now running at 2.3% year-on-year, the apparently non-threatening nature of current readings obscures less quiescent underlying trends. Year-on-year, core PCE is now running some two-thirds faster than its pace of about 0.96% in late 2003. And in the last three months, the deflator is up 2.1% at an annual rate.

Thus, statistical and methodological issues concerning which official indicator is best reflecting the inflation environment are, from our perspective, beside the point. In a $10 trillion economy with the attendant price-system complexities, all such data aggregates are unavoidably backward looking. A key question now is whether the Fed recognizes the implications of such lags and is prepared to conduct policy accordingly. If not, the central bank risks allowing still mild current inflation to ratchet significantly higher, whether measured by PCE, CPI, PPI or anything else. That would, given the Fed's inherently behind-the-curve operating approach, inevitably elicit a more assertive and potentially destructive tightening response than would be required to quell the price pressures were appropriate action taken now.

We estimate that there is an 18 to 24 month lag before Fed policy is reflected in the price indices, and recent experience supports that view. Core CPI, for example, bottomed at 1.1% year-on-year in December 2003, just short of two years after the first signs of a concerted Fed reflationary thrust showed up in foreign exchange and commodity prices in early 2002. That also suggests that the past two years of extraordinarily easy monetary policy, during which the dollar has fallen on net some 20% against foreign exchange and 30% against gold, has yet to be reflected in the price data. It also frames the risk implied by Fed policy being steered toward complacency by current statistical inflation, overlooking the reality of building price pressures.

The market price indicators suggest a considerable degree of ongoing unease in that regard. We found it revealing that the dollar last week didn't fully recover its losses sparked by reports Tuesday -- subsequently dismissed -- suggesting that **South Korea** was considering lightening its holdings of dollar reserves. The minutes of the early February **FOMC** policy meeting, released Wednesday, appear to have short-circuited a strong dollar bounce-back. According to the minutes, policy makers saw the funds rate, now 2.5%, as "remaining below levels that might reasonably be associated with maintaining a stable inflation rate over the medium run." While that would seem to augur for a continued course of rate normalization, the minutes immediately

added that "the pace of policy moves at upcoming meetings…would depend on incoming data." In other words, any hint of a slackening in growth would likely prompt at least a pause in the rate-hiking cycle, in keeping with the flawed paradigm under which the Fed seeks to fine-tune real economic outcomes. At the same time, though, the central bankers seemed to signal that no interruption in the current course was currently anticipated, asserting that "core inflation likely would remain low and stable, *assuming further removal of policy accommodation*" (emphasis added). With a policy orientation this confused and contradictory, no wonder the markets aren't giving the Fed the benefit of the doubt.

Bottom Line: Today's surprising 0.3% jump in the core personal consumption deflator, sparking a three-quarter point selloff in the 10-year note, appeared to put the market on notice that its stubbornly sanguine inflation outlook could be highly vulnerable. The benchmark Treasury yield, at 4.37%, has climbed nearly 40 basis points from its levels at the market's peak of complacency just less than three weeks ago, and could face further significant headwinds as the market belatedly comes to terms with a long-denied reality. TM