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Stag No, Flation Yes

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Thankfully, the Fed shows no sign of bowing to the pundits' scare stories.

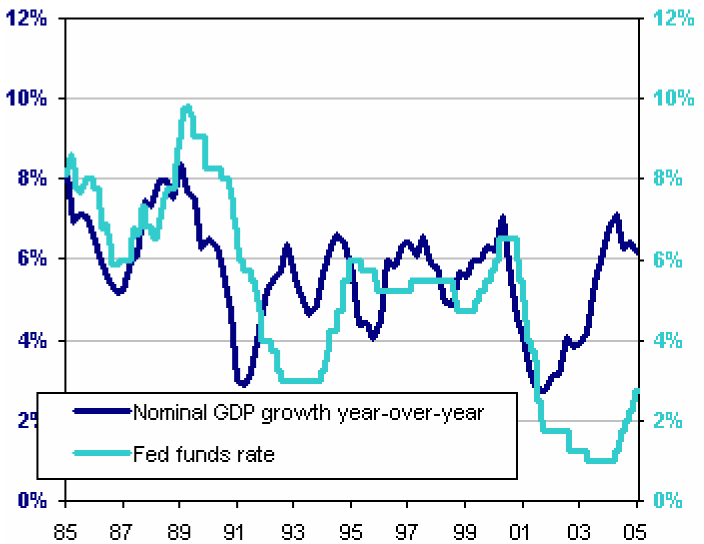
The combination of a supposedly sharp **growth slowdown** and noticeably higher **inflation** has given shallower thinkers among the keepers of conventional economic wisdom a handy excuse to dust off their jargon memory banks and spot the reemergence of **"stagflation"** on the near horizon. For some (see leftist propagandist **Paul Krugman**), it's just more of the predictable twaddle on the theme of the coming **Bush** economic Armageddon. For the most part, though, raising the demon of stagflation appears aimed at posing a quandary for **the Fed** where, in fact, none exists. Fortunately, the Fed today gave little hint that it is being swayed by the chatter, and appears poised to remain on track for a steady course of policy normalization. Indeed, the greatest risk of a stagflation episode would arise from the Fed cutting short this rate-hiking cycle, sanctioning an inflation acceleration to significantly higher levels. Not only would the rising risks to capital be corrosive to risk taking and capital formation, but the central bank would inevitably be compelled to launch an aggressive tightening campaign in the midst of what could be, by then, an already faltering economy.

Last week's advance estimate of 3.1% first quarter **GDP** growth was widely interpreted as confirmation of a significant downshift in the pace of expansion, but after adjusting for the rigid and archaic conventions of national income accounting, we saw little evidence of actual deceleration. Whereas in the real world rising **imports** are a reflection of robust and healthy growth, the **Commerce Department's** GDP calculations are a mercantilist throwback, treating imports as a debit to domestic output. Thus, the 14.7% growth of imports in the first quarter subtracted fully 2% from the GDP growth rate. In other words, abstracting from this piece of statistical arcana, the economy was actually expanding at a better than 5% rate in the quarter, which hardly counts as "slow."

Similarly, the **ISM's** April manufacturing survey released yesterday showed a decline in its activity index from 55.2 to 53.3. The ***New York Times***, in a gloom-and-doom accounting of recent economic news today, couldn't resist characterizing the index as having "dropped sharply," but in fact it was the 23rd consecutive month of readings above 50 -- indicating growth -- the longest such stretch since the late 1980s. The ISM itself said the April index is consistent with a GDP growth rate of 3.8%, which somehow was overlooked by the *Times* in its compilation of today's morose report.

Meanwhile, market-based indicators of risk tolerance which we monitor to gauge growth expectations suggest the outlook for sustainable growth remains good. It's true that **junk bond credit spreads** have backed up by about 100 basis points in the past couple months from what were inordinately low levels. But current high-yield spreads around 400 basis points are still at levels that have historically been associated with a solid pace of expansion.

But while the "stag" half of the stagflation formulation is significantly overdone, we cannot offer similar assurances about the "flation" half. The trend shift in reported statistical inflation has become apparent even in "**Greenspan's** favorite" indicator -- the **core personal consumption expenditures deflator** -- which until recently had been offering significantly more subdued readings than **core CPI**. In the past three months core PCE is up at a 2.9% annual rate, versus less than 1% as recently as last September. On a year-over-year basis, the core PCE is still advancing at a rate of just 1.7% (the core CPI is up 2.4%), but it was barely above 1% until the second quarter of last year. It's worth noting as well that at 1.7%, the year-over-year core PCE is near the top end of the Fed's "central tendency" forecast of 1.75% for the year.



One perspective on the degree to which the Fed, even after 200 basis points in rate hikes, remains behind the curve is provided by the chart at left, plotting **nominal GDP** growth against the **fed funds** rate. Nominal -- or "money" -- GDP can be seen as a proxy for economy-wide returns and opportunity costs. The still-yawning chasm between the funds rate and nominal GDP is one measure of the extent to which the Fed remains "easy," encouraging borrowing at a rate below the equilibrium cost of funds, and thereby continuing to feed a liquidity surplus.

Bottom Line: Recent talk about the possibility of stagflation appears aimed primarily at eliciting apprehension about the Fed's rate-normalization strategy. If the Fed is raising rates to quell inflation in the face of an already slowing economy, the purported risk is that it could soon throw the economy into recession. We find little to support the notion, however, that the current outlook for growth should serve as a constraint on needed Fed action. With its post-**FOMC** meeting announcement today, the Fed reaffirmed that its first priority is to continue removing policy accommodation to deal with the inflation pressures which "have picked up in recent months." TM