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

FED SHADOW

Department of Corrections

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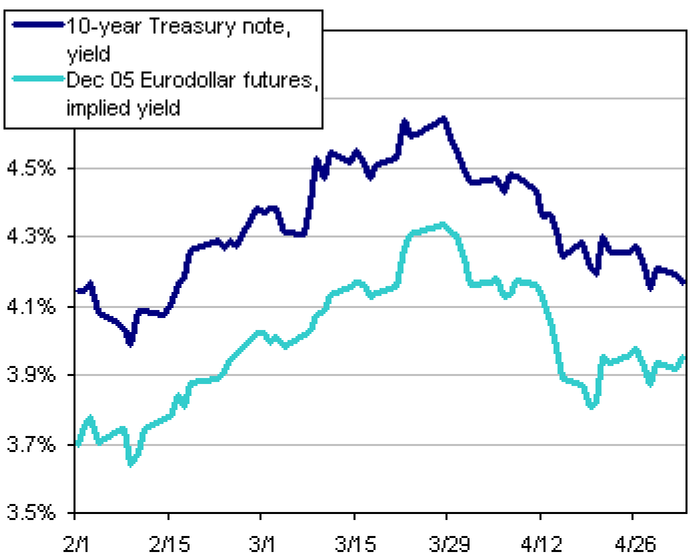
Donald Luskin

The FOMC corrected its statement yesterday -- but when will the Fed correct the bond market?

One can only imagine the scene of panic and mortification at **the Fed** yesterday when it was discovered that a sentence had been inadvertently left out of the **FOMC's** statement -- "Longer-term inflation expectations remain well contained." For an institution that values credibility above all, it must have been excruciating to issue an unprecedented corrected statement. What, in the Fed's collective mind, could have justified taking that extraordinary step? What was so important about that omitted sentence?

The omitted sentence is especially interesting in light of the *intentional* omission of another sentence that had appeared in the previous meeting's statement -- "The rise in energy prices, however, has not notably fed through to core consumer prices." By omitting *that* sentence from the current statement, the Fed is saying that **energy prices** *are* feeding into **inflation** *now*. The product of considering together both the *unintentional* and *intentional* omissions is: "We finally admit that inflation is embedding itself in the economy, but we can't fail to acknowledge that the bond market still disagrees." So we can reframe our question as, what was so important about giving that tip of the hat to the **bond** market?



It may reflect the Fed's own ambivalence. Having only admitted for the first time at the previous FOMC meeting that there's any evidence of inflationary pressures (see "About Time" March 21, 2005), the Fed may not be ready to declare that the presumably wise and far-seeing bond market is wrong -- or even suggest that it presents anything more troubling than a "conundrum." If that's what's going on, it's a big mistake -- because the conventional wisdom about the wise bond market is getting increasingly foolish. For example, the reality is that the **10-year Treasury** yield has perfectly tracked changing expectations in the **Eurodollar futures** markets for the year-end **Fed funds** rate (see the chart at left). Yet when confronted with the possibility that the funds rate will be 4.25% at year-end via 25 basis point rate hikes at every FOMC meeting, serious commentators are now suggesting that the 10-year will stay right where it is now, at 4.2%. If the **yield curve** has to **invert**, then so be it -- as though today's 10-year yield were a fixed point around which the rest of the financial universe must revolve. How reminiscent of late 1999 and early 2000, when **NASDAQ** bulls argued that a steeply rising funds rate couldn't possibly inhibit the **"New Economy."** The conventional wisdom then was that the NASDAQ was worth 5000 *no matter what* -- and today it's the same with the 10-year at 4.2%.

Or, by dignifying the inflation denial embedded in today's bond valuations, the Fed may be struggling with a "conundrum" of its own making -- the paradoxical fact that low bond yields may not be signaling low inflationary expectations, but may in fact be the most visible symptom of inflation itself. No, we are not making a case for the notion of **"asset inflation."** Yet it is true that if inflation is an excess of money liquidity relative to demand, the money has to go *somewhere*. In an inflation, cash is a hot potato -- an overabundant and depreciating asset that must be converted into some other form. Of course when a holder of cash converts it into some other asset, such as bonds, he simply passes his hot potato on to the seller (who must demand a high price, as a result). The only market participant who can actually extinguish excess cash is the Fed itself -- by selling bonds in open market operations. But with the funds rate below equilibrium as it is now, the Fed is *not* a seller of bonds -- if anything, it is the marginal *bond buyer*. And so we see a world awash in dollar liquidity, desperately reaching for yield -- driving bonds to absurd heights, and crushing credit spreads, all amplified as thousands of newly minted hedge funds crowd into "what's working." It's more than a conundrum -- it's a **bubble**. *If* the Fed sees that, then yesterday's corrected statement was to reduce the shout of "Fire!" in a crowded theater down to a discreet whisper.

Bottom line: The Fed took extraordinary measures yesterday to nuance its increasingly strong inflation warning to the bond market, perhaps both out of respect for the bond market's expectations and fear for the consequences of too aggressively pricking a bond bubble. But inflationary forces remain in play, and the Fed will have little choice but to continue to raise rates as the year unfolds -- and bond yields will have little choice but to rise, too. TM