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FED SHADOW

Fed, Still Behind the Curve

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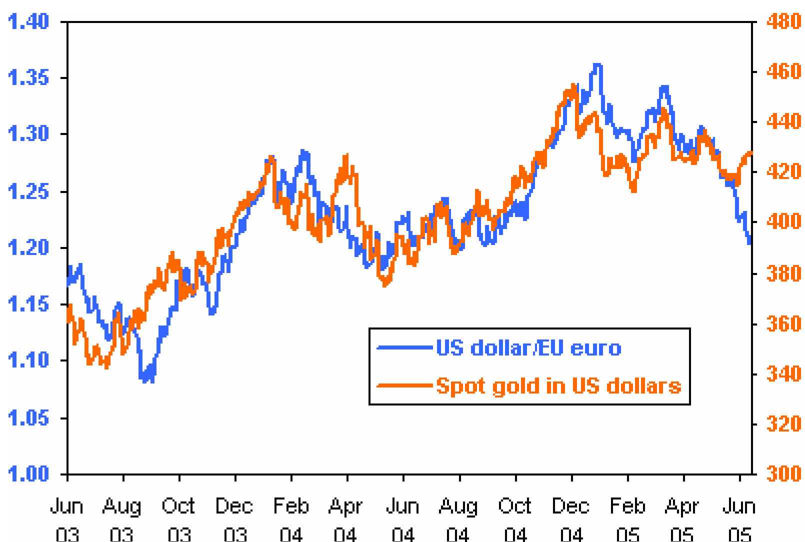
This month's seemingly strong dollar masks dangerous underlying weakness in Fed policy.

When the May **CPI** release showing a **core inflation** rate of just 0.1% hit the wires yesterday morning, the biggest market response came not in **bonds** or **interest rate futures**, which might have been expected to rally on the seemingly "good" news. The biggest response came in **gold**, which jumped some two dollars within minutes and is today maintaining its rally footing, up more than six dollars and sustaining trade above $435 for the first time in three months. A wag once observed that gold can be very vexing to government authorities and conventional consensus thinking because it "tells the truth." In the current policy context, the "truth" is **the Fed** is still too easy, and a premature end to the **rate normalization** process -- in keeping with accepted wisdom that price pressures are nonexistent -- would be a significant inflationary error.

In interpreting the significance of contemporaneous data from the official **price indexes**, it's important to keep in mind that these are greatly lagging indicators, reflecting conditions existing probably on the order of 24 months in the past. Recall that two years ago, in late spring 2003, the Fed was in the throes of **deflation** panic, and was on the verge of cutting the **fed funds** rate target to its rock bottom low of 1%. At that time, gold was trading in a range around $350, having **reflated** from the sub-$300 levels of the prior several years, but still within sight of the long-run moving average around $330 consistent with rough **price stability**. Current year-on-year core CPI of 2.2%, then, does not yet reflect the hyper-accommodative phase of Fed policy starting in the second half of '03, and which by late in the year had gold running above $400 where, except for a couple brief intervals last year, it has stayed in the ensuing months.



This latest episode of real **dollar weakness** reflected in the $20 jump in gold since the beginning of this month has been masked to some extent by the even greater real depreciation of some **foreign currencies**, particularly the **euro**. As seen in the chart at left, for most of this recent period the euro has been a spot-on reflection of changing dollar purchasing power reflected in the dollar price of gold, largely strengthening as

the **US** currency continued to lose ground in terms of gold. As a consequence, as dollar gold moved steadily higher, the euro price of gold remained remarkably stable in a range around €335 the past two years. Since late last month, however, coinciding with voters rejecting the **European Union constitution** in **France** and **Holland**, euro gold has jumped from €338 to €360, a 6.5% move, while the move in dollar gold has netted about 5%. The dollar's recent "rally" against the euro, in other words, has been a matter of the European common currency weakening even more than the dollar.

It is somewhat disconcerting that this deterioration in the real value of the **unit of account** has developed even as a somewhat more rational view of the job still ahead for the Fed has been reflected in market expectations. Since hitting an intra-day low of 3.80% on June 3, the**10-year Treasury yield** has backed up by some 30 basis points, with **December Eurodollar futures** now priced odds-on for a 3.75% year-end funds rate, versus 3.5% early in the month. The market response would suggest, however, that the overnight rate target would still be too low if it tops out below 4%. In addition, the pop higher in gold has coincided with other indications of a recent deepening of surplus liquidity supplies. Since last month, the Fed's holdings of dollar assets for **foreign central banks** has jumped by some $40 billion, after remaining largely stable the previous two months. These custody holdings can be seen as a reflection of the net excess dollars that turn up at foreign central banks as a consequence of dollars being dumped in favor of other currencies in market transactions. It could be that this additional dollar surplus developed as a result of speculation suggesting the Fed would be calling an early halt to the policy normalization process, and the more recent turn in expectations might help reduce the excess. But it could also be an indication that the Fed is further from its objective of reaching **policy "neutrality"** than all but the most hawkish observers would want to admit.

Bottom Line: The dollar's decline in purchasing power in terms of gold indicates the risks and uncertainties still confronting the market in attempting to price for the Fed's current and most likely future policy stance. A good part of today's jump in gold, for example, came following a weaker than expected report on **Philadelphia** area manufacturing conditions, which sparked a modest rally in fixed income markets on slightly reduced out-month expectations for Fed rate action. A market balancing on such a knife's edge of risk and expectation suggests the stakes are sharply rising for the Fed to get it right. TM