TrendMacrolytics

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

FED SHADOW

Cat Out of the Bag?

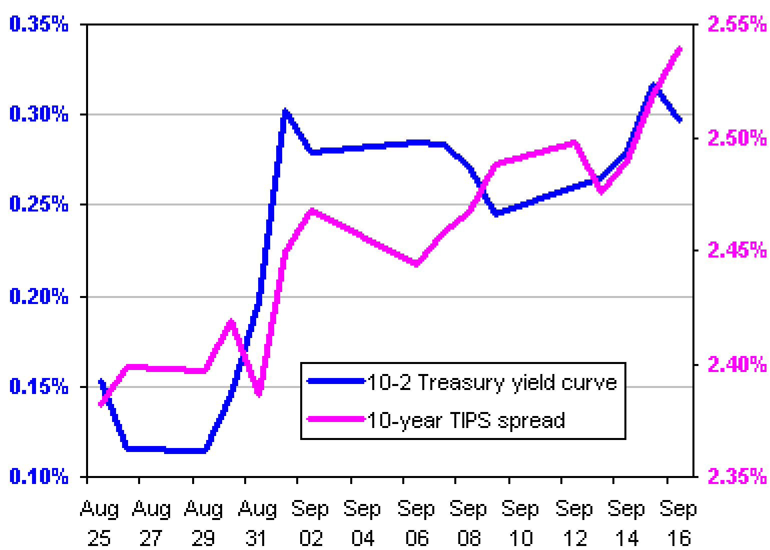
Monday, September 19, 2005

David Gitlitz

Gold's inflation warning is too obvious for even the post-Katrina Fed to miss.

The sight of **spot gold** reaching fresh 17-year highs above $460 in such close proximity to tomorrow's **FOMC** meeting, we can only hope, is not completely being ignored within the marble corridors of **Fed** headquarters. Amid nascent indications that the **long end** of the **Treasury yield curve** might finally be recognizing long-suppressed **inflation** realities, the latest gold price spree -- up more than $30 since late last month -- stands as clear warning that any departure by a still behind-the-curve Fed from its **rate normalization** course risks inflicting serious **policy error**.

There's not much uncertainty remaining about the specific result of tomorrow's meeting. While odds favoring another 25 basis point move tomorrow were significantly marked down in the **futures markets** in the early post-**Katrina** panic, that move was nearly completely reversed with the dearth of evidence supporting an immediate pause. The suspense attaching to tomorrow's session concerns changes that might be made in the language of the post-meeting statement. Certainly, we don't rule out the possibility of the Fed taking this occasion to modify certain key phrases. The assertion that the "stance of monetary policy remains accommodative," for example, has been an unmistakable signal that the Fed has seen its task remaining unfinished. With 275 bps in cumulative **rate hikes** putting the target at 3.75%, it's likely some sentiment will be heard within the panel tomorrow for that language to be dropped. Several FOMC members have been on record citing 3.5% as the lower end of a range that could be considered **"neutral."** With the **target** now set marginally above that level, it's conceivable that tomorrow will see calls for a meaningfully **dovish** change in that phrasing.



While the risks implied by such a potential change in the policy outlook no doubt have been a factor in the erosion of **real dollar purchasing power** seen in the soaring gold price, we also don't rule out the possibility that any substantive modification in the statement tomorrow will be in a more **hawkish** direction. The relevant phrase of the announcement likely open to alteration in this regard is the assurance that "accommodation can be removed at a pace that is likely to be measured." With the exception of **Alan Greenspan**, few -- if any -- of the current FOMC members have a grounding in the monetary significance of gold. Most do, however, understand the basic logic of rising **bond yields**, particularly when the nearly 30 bp spike seen in recent weeks is accompanied by an abrupt yield curve **steepening** and a jump in the **spread** between **nominal** Treasuries and their **inflation-indexed** counterparts (see the chart on the previous page).

Indeed, we have been struck by the voices of conventional economic wisdom who now concur that this bond market sell-off has been an inflation event, with some acknowledging that it renders inapt any call for an early end to this policy cycle. Moreover, while the futures have taken out any chance that the Fed will pass on a rate hike at tomorrow's meeting, such is not the case in out-month contracts. In pre-Katrina late-August trading, for example, January **fed funds futures** were priced for a better-than 80% chance of a 4.25% funds rate being in place by the end of this year. Now, the contract is priced for 4%. Greenspan and company could well be inclined to find some way to signal that at this point they have no intention of departing from their 25 bp per meeting pace.

In so doing, they might also be motivated to dampen any lingering speculation that the **Gulf Coast** dislocations wrought by Katrina are likely to prove a major **economic shock**. In fact, we see little sign in sensitive, forward-looking market indicators suggesting that the event has made any appreciable dent in **growth** expectations. Gauges of risk preference that we monitor -- the **Merrill Lynch high-yield bond spread**, for example, is now just above 350 bps -- suggest the environment for **risk capital formation** remains vibrant, which is invariably positive for sustained growth. At this point, the greatest threat to such continued vibrancy would come if the Fed stays too long behind the inflation curve and is ultimately compelled to take aggressive remedial action to contain its error.

Bottom Line: This gold price spike stands as a stark reminder of the precarious state of the current policy environment. While gold provides valuable insight into the risks involved, our best bet is that the Fed will not be diverted from its current course, and is more likely tomorrow to strike a marginally more hawkish rather than dovish tone in the post-meeting statement. Fact is, though, while remaining on this path will at some point put the funds rate at an **equilibrium level** no longer imparting additional inflationary influences, that's unlikely to bring much solace to long term **bond holders**. Bonds inevitably face a deep repricing for the impending inflation reality, of which the sell-off of the past few weeks has offered only an early hint. TM