TrendMacrolytics

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

FED SHADOW

No Dove

Tuesday, November 1, 2005
David Gitlitz

The risk in a new Bernanke Fed is overshooting in the direction of tightness.

Demonstrating again that **"conventional wisdom"** is often a contradiction in terms, the latest ***Barron's*** insists that last week's **bond market** sell-off "reflected the widespread belief among economists, strategists, traders and investors that Bernanke will be softer on inflation than Greenspan was." In case readers miss the point, the piece helpfully explains that "Because inflation erodes the value of fixed-income securities, investors last week pushed up Treasury yields to compensate for the perceived risks of inflation…"

Barron's, of course, was hardly alone in making the **"dovish on inflation"** assertion. Many of the early reports on **Ben Bernanke's** nomination as **Fed chair** referred to his remarks in November 2002 concerning the options available for the Fed to fend off any potential **deflationary** thrust including, if need be, dropping **money** from helicopters. For many, that speech has come to symbolize Bernanke's supposed inflation dovishness.

Fact is, though, there has been virtually no sign of **credit markets** discounting a higher **inflation** premium since Bernanke's appointment. Even as the **10-year Treasury** tacked on nearly 20 bps to post a yield just below 4.6%, on net the **10-2 yield curve** -- at about 17 bps -- has been unchanged since the close on October 21, the Friday before last Monday's announcement of Bernanke's nomination. The **spread** between 10-year Treasuries and **CPI-indexed TIPS** has widened by about six bps. But at 257 bps, the TIPS spread is no higher than it was the week before the announcement -- and remains more than 200 bps below the current year-on-year CPI.

Rather than the **long end** of the curve getting hit disproportionately as would be the case if rising inflation expectations explained the market's downdraft, this has been an upward shift of yields across the curve, a move consistent with **rising real rates**. And the source of the yield upshift stands in direct contradiction to the Bernanke-as-inflationist story. Markets aren't pricing for the Fed moving to the sidelines once Bernanke takes the helm in February. Quite the contrary, out-month **interest rate futures** have significantly upped the odds on further Fed action beyond **Greenspan's** departure early next year. The day before the nomination, **fed funds futures** were priced odds-on for a 4.5% target rate at mid-year. They have now moved to an 80% chance that the late-June **FOMC** meeting will ratify a 4.75% rate.

By his own lights, Bernanke is no more a dove on inflation than he is on deflation, as he prepares to take over the Fed chairmanship. The problem, however, lies in the backward-looking real economic indictors -- **job creation, capacity utilization**, etc. -- that form the key variables in the **neo-Keynesian output-gap model** that he and the **Fed bureaucracy** adheres to. More often than not, this leaves policy behind the curve and prone to **overshoot** on both the dovish **(easing)** and **hawkish (tightening)** side. Bernanke's November '02 deflation speech, in fact, marked the outset of the Fed's campaign to subdue downward **price pressures** that

http://www.trendmacro.com
don@trendmacro.com
dgitlitz@trendmacro.com
tdemas@trendmacro.com

Offices:
Menlo Park CA
Parsippany NJ
Charlotte NC

Phone:
650 429 2112
973 335 5079
704 552 3625

various **market price indicators** including **gold**, **commodities** and **foreign exchange** indicated were already well on their way to being rooted out. By maintaining this exceptionally **accommodative** stance through mid-2004, the central bank moved from a constructive **reflationary** posture to one that led to a precipitous **dollar weakening** carrying significant inflationary risks.

Even after today's FOMC meeting puts the **funds target** at 4%, which will have seen the Fed raise the rate by a total of 300 bps in the past 16 months, with a real rate of 2% (relative to the **PCE core deflator**) the Fed remains accommodative. An additional 75 bps in the coming months, as the market now expects, should absorb much of the remaining **monetary slack**, without in itself presenting a significant risk of overshoot. Indeed, we are heartened to see gold, apparently responding to these expectations, continuing to descend from the mid-$470s, today touching below $460 for the first time in six weeks. Even as the Fed moves toward **equilibrium**, however, the readings on **core inflation** yielded by the **statistical indexes** are likely to move higher, as more of the consequences of the Fed's excessively easy posture fully surface in the deeply lagging data. Our concern is that a Bernanke-led Fed will feel compelled to respond assertively to what could be a significant *statistical* inflation uptick, despite the fact that it reflects past error that current policy has no power to affect. The potential for overshoot in that event should not be overlooked.

In any case, while the usual speculation about today's FOMC session centers on the possibility of a meaningful shift in the post-meeting statement, we look for a largely *status quo* announcement. In addition to the fact that the panel likely does not perceive that a significant change is warranted in the formulation that "accommodation" can be removed at a **"measured pace,"** our hunch is that policymakers will approach the task with considerable caution in this transition period. They are not likely to want to take the risk of appearing to foreclose any options for Bernanke when he takes office in three months. Deleting or significantly altering the references to "accommodation," for example, likely would be read as signaling that this **policy cycle** is near its conclusion, an impression that Bernanke likely would not want to convey at this point.

Bottom Line: Fixed income markets have responded to Ben Bernanke's appointment as Fed chairman by pricing in a significantly higher likelihood of further rate raising after Alan Greenspan leaves office early next year. How much additional action is actually effectuated, of course, remains an open question, but we think it likely that the new chairman won't want to take any early steps that will raise any question about his anti-inflation credentials. While the futures curve has moved to price for a 4.75% funds rate by mid-2006 -- versus 4.5% prior to the nomination -- we think a rate move is highly likely at Bernanke's first FOMC gathering in late March, which likely would put the target at 5% by mid year.