TrendMacrolytics

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Greenspan's successors will have to live with a legacy of inflationary risk.

As **Alan Greenspan** in one week's time faces the final policy meeting of his celebrated 18-year run as the world's premier central banker, it's a safe bet that he'd prefer not to be leaving the stage with the price of **gold** -- at above $550, up nearly 50% in a little more than two years --and the **dollar** resuming its downward trek on **foreign exchange** markets. Greenspan will do what he can with his remaining authority to restrain the **liquidity glut** that continues to be manifest in **market price gauges of relative dollar strength**. He rearranged the scheduled timing of his final **FOMC** meeting to ensure that he would be on hand to put the **funds rate** at 4.5% before taking his leave. But he exits with a big question hanging over the monetary scene: whether **the Fed** is prepared to do what is necessary to keep an already assured moderate rise in the **price level** from becoming a more destructive **inflation breakout**.

"The Maestro" gave short shrift to **price-rule principles** in the second half of his tenure, when an influx of **neo-Keynesians** at the Fed forced his hand and put the **output gap/Phillips curve** approach based on deeply flawed **demand-management** dogma at the policy forefront. Despite the absence of market-price indicators from his publicly professed policy guideposts, his intellectual tradition leaves little doubt that he well understands the consequences of the erosion in **real dollar purchasing power** indicated by sensitive **commodity prices** and foreign exchange. Ironically, he leaves office with his abandonment of the price-rule model having laid the groundwork for the inflationary upswing now in train. It was the rigidities of output gap doctrine that produced the highly **deflationary tightening regimen** of the late 1990s. The belated recognition of that error precipitated the extraordinary exercise in **monetary accommodation** which left the Fed far too **easy** for far too long. Reversing that **hyper-accommodative** stance and restoring **monetary equilibrium** is now requiring a more extensive run of rate hikes than most observers could have been anticipated at the outset of the process in mid-2004.

The early **post-Greenspan era** at the Fed will be primarily an exercise in attempting to determine how much further rates need to rise before a **"normal" level** is reached. The rampant **"one and done" speculation** is based primarily on the notion that a **slowing economy** will put policy on hold after next week. As described in our report last week (see "Slowdown?" January 19, 2006), we see little evidence supporting that contention. Friday's **GDP report**, however, could lend surface credence to the slowdown idea, as distortions arising from the severe **hurricanes** of late last summer could show up in the data as a softening of **consumer spending**, pulling reported fourth quarter **GDP growth** to levels around 3%, down from the third quarter's 4.1%. A weaker-looking fourth quarter might create a short-run distraction, obscuring the fact that the economy at this point poses no obstacles to the Fed continuing with the task at hand.

Indeed, the greater risk by far would be a premature pause in the **policy normalization process**, further deepening the liquidity excesses now apparent in the market price indicators and ultimately requiring an aggressive Fed response that would likely put an end to this **expansion**. Amid the widespread consensus that inflation is a nonissue and has essentially been consigned to the scrap heap of economic history, there are some contrary inklings in the conventional data worth a closer look, for those who refuse to credit the evidence in commodity and currency markets. The **Consumer Price Index less energy**, for example, has risen at an annual rate of 2.8% in the last three months. Three months does not amount to a conclusive **trend shift**, but the chart at right-- showing three-month annualized rate of change in non-energy CPI on a three-month moving average basis -- should at least give one pause before pronouncing the death of inflation. The trend lower in non-energy inflation didn't bottom out until mid-2003, the lagged effects of the Fed's massively **too-tight** stance of the late '90s. Since then there has been a non-negligible move to higher levels in response to the Fed's highly accommodative stance, the bulk of which has yet to feed through the deeply **lagging price indexes**.

All of this continues to point to **long term bonds** at today's still-rich levels being a bad bet. Whether or not the Fed pauses prematurely in the first half of this year, the longer term outlook for both rates and inflation raises serious doubt about the sustainability of **10-year Treasury yields** of less than 4.5%. A glimpse into the irrational nature of the current market environment came yesterday as the 10-year Treasury reversed early losses of nearly three-eighths of a point. According to one market news service, talk on the **trading floor** was that the bounceback was in part due to the falling dollar supporting sentiment that the Fed must be nearly done. It would seem that something must be amiss when a *weakening* of the currency is an excuse for the *rising* price of a fixed income asset the value of which is ultimately a function of the real purchasing power of the **unit of account**.

Bottom line: Greenspan prepares for his final FOMC meeting against the backdrop of a variety of indicators showing that the Fed remains in an excess liquidity posture. Notwithstanding the near-universal acclaim coming his way, Greenspan's final legacy will be the inflationary error that he is leaving behind, the cause of which can be directly traced to his earlier deflationary error. As speculation rises that the end of the policy normalization exercise is near at hand, the post-Greenspan Fed must determine how much further rates must rise to reach equilibrium. Uncertainty surrounding the exact path that rates will take over the next several months has increased over the last several weeks. But our base case remains that the **real macroeconomic indicators** guiding policy point to further action than now anticipated by the market, with the **funds rate target** reaching 5% by mid year. TM