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# On the FOMC Meeting

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**David Gitlitz**

While raising the **fed funds target** to 4.5%, **FOMC** today probably did about as much as could realistically be expected to signal the likelihood of further corrective policy action without foreclosing the options facing **incoming chairman Ben Bernanke**. The only notable change in this statement from last month's was in the somewhat less definitive assertion that "some further policy firming *may* be needed," versus last month's declaration that "some further *measured* policy firming *is likely to be* needed" (*emphasis* added). Together with the more hedged characterization about prospective action, removal of the word **"measured"** was probably intended to insure that the statement does not appear to be tying Bernanke's hands in shaping future **policy decisions**.

Otherwise, this statement shows that **the Fed's** basic institutional perspective on the policy outlook remains unchanged, with a clear bias toward remaining on the **current course**. As much as dismissing **the fourth quarter GDP** report as a one-time aberration (an assessment with which we concur), the statement said, "Although recent economic data have been uneven, the expansion in economic activity appears solid." After the customary boilerplate about **inflation expectations** remaining "contained," the statement repeats last month's bottom-line assessment: "Nevertheless, possible increases in resource utilization as well as elevated energy prices have the potential to add to inflation pressures." The Fed's **demand-based output-gap models**, in other words, are flagging the risks of continued **"above-trend" growth**. We continue to see the Fed as unlikely to stand down from the **rate-hiking process** in the face of such growth prospects, and we doubt that Bernanke is bringing a substantively distinct perspective to the job on that score.

The important point is that, as yet, the Fed is showing no inclination to call a too-early end to this **policy normalization process**. From our perspective, under which the stance of policy is assessed through its effects on various indicators of the currency's **purchasing power**, the Fed is doing the right thing for the wrong reasons, but at least it's doing it. Under the Fed's policy guideposts based on **real macroeconomic indicators** of relative economic **"slack,"** we see this cycle as unlikely to end before the funds rate reaches at least 5%.

While we have emphasized the erosion of the **dollar's value** in terms of **gold**, the inflation indicator *par excellence*, some who generally share our market-price orientation had remained sanguine on the inflation outlook due to what was seen as a lack of confirmation in broader **commodity** groupings, **foreign exchange**, and **bonds**. More recently, however, all of these have moved into broad alignment in signaling eroding dollar purchasing power and rising inflation risk. In fact, gold was never alone, with various **metal** and **industrial commodity indexes** at or near record highs. But the signs of incipient inflation have clearly been spreading, and are no longer confined to a few indicators. The **non-energy CRB Spot Commodity Index** is now at nine-year highs, up 5.5% since late November and nearly 7% over the past year. The dollar's foreign exchange value had been benefiting through much of the fall from other currencies -- especially the **euro** and **yen** -- weakening even more in **real terms** than was the

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dollar. But in the past two months, the dollar's softness has again become apparent, with the **G-6 Trade-weighted Dollar Index** falling by some 4%. Finally, it appears that some recognition of inflation reality is oozing into the bond market. Not only have **long-term yields** jumped more than 20 basis points in the past two weeks, with the **10-year Treasury** today yielding 4.52% since early this month the **TIPS spread** has widened by about 25 basis points, indicating that the protection of **inflation-indexed debt** has become marginally more appealing to increasingly inflation-wary **fixed-income investors.** TM