TrendMacrolytics

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On Bernanke's Testimony

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Ben Bernanke's maiden appearance before **Congress** as **Fed chairman**, much as it was eagerly awaited far and wide, had little impact on **credit markets** which were largely priced for the basic message that further **monetary firming** "may be necessary," with additional **policy adjustments** "increasingly dependent on incoming data." More notable, we think, was the action in the **gold** pits as the monetary metal fell as much as $10 during the testimony, to below $536, before recovering some lost ground to close the **New York** session at just under $540.

While gold trading remains highly volatile, indicating a high degree of **risk** continues to attach to this most sensitive gauge of **dollar purchasing power**, it seems clear there's been a non-negligible shift in **sentiment** since gold reached 25-year highs around $575 just two weeks ago. A good part of that, we believe, is attributable to recognition that the **economy**, which continues to exhibit impressive strength, is unlikely to pose an obstacle to the Fed continuing to move toward policy **equilibrium**.

That came through clearly in Bernanke's testimony today, with the new Fed chief using the central bank's familiar **output gap** formulations to underscore that the economy's vitality very likely means that this **rate cycle** has somewhat further to go. "The economy now appears to be operating at a relatively high level of resource utilization," he said. "The risk exists that, with aggregate demand exhibiting considerable momentum, output could overshoot its sustainable path, leading ultimately--in the absence of countervailing monetary policy action--to further upward pressure on inflation."

While emphasizing that **"incoming data"** would be critical in policy decisions going forward, Bernanke said nothing about the signals from **commodities** and other **market price indicators** of extended dollar weakness on a scale which has historically presaged significant **inflation** increases. It's worth noting, though, that the **"central tendency"** of the **FOMC** forecast accompanying Bernanke's testimony calls for the core **personal consumption expenditure** price index to rise at a rate of 2% this year. In the last quarter, however, it rose at an annual rate of 2.2%. The Fed, we believe, is unlikely to call an end to this rate hiking cycle with its preferred measure of **core inflation** already running above its comfort zone. Moreover, the dollar weakness reflected in various market price indicators in response to the Fed's highly **accommodative** posture of recent years translates into higher upside than downside risk for the statistical inflation indicators this year.

Until very recently, we were far outside **consensus** in seeing this **policy normalization** process as unlikely to end before the **funds rate target** was raised to at least 5%, probably by mid-year. Today, **Fed funds futures** are nearly fully priced for that eventuality. At this point, **the two-year note** at about 4.7% is posting the highest yield on the **Treasury curve**. While its yield has also moved higher in the past few weeks, it continues to reflect the view that the Fed will be compelled to start **cutting rates** soon after ending the **tightening cycle**, a proposition which is

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also reflected in the **inversion** of the **yield curve**. We think that will prove to the wrong bet, and that at this point the greater likelihood is for the funds rate to settle at a level higher rather than lower than 5%, with negative implications for Treasuries across the curve. TM