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Sorry -- Still Not Done Yet

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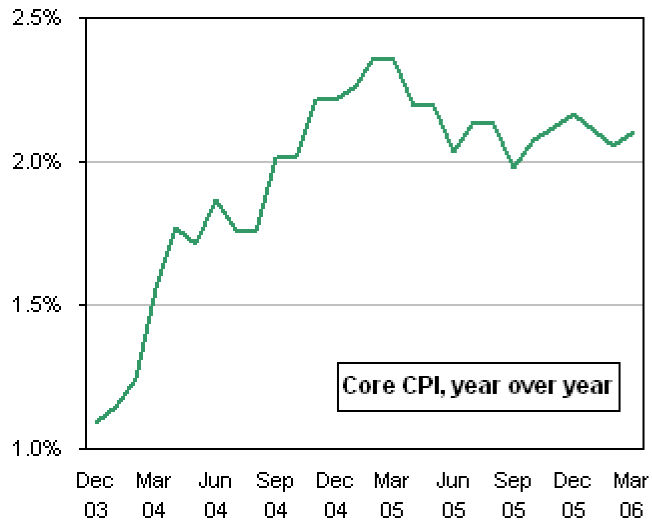
The Fed is still data-dependent, and all the data points to more rate hikes.



Just one day after **credit markets** were pushed higher on hopes that the **minutes** of **the Fed's** late March policy meeting were signaling a near-term end to its **rate-hiking exercise**, prices reversed on an unwelcome sign that **core inflation** might not be the dead letter it is widely assumed to be. Yesterday's report of an 0.3% jump in **core CPI** was as big a jump as any in more than four years. And it contained hints suggesting that factors that have been holding the core measure in check could be unwinding, pointing to a continuation of the **trend reversal** toward higher **statistical inflation** that began after the bottom in December, 2003.

Perhaps most disquieting of all has been the continued rally in the price of **gold**, now at its highest levels since 1980, offering a clear warning that the Fed's inflation-biased **excess liquidity** posture has yet to be reined in. Gold stands today 85% above its ten-year moving average. If we think of **spot gold** as representing prices based on contemporaneous appraisals of **expected dollar purchasing power**, and the ten-year moving average representing the mass of **"sticky prices"** embedded in **the economy** at large, then the 85% gap between them represents an enormous amount of **catching up** in store for the **general price level** over time. With gold here, our **regression analysis** outputs a forecasted core inflation rate between 4.8% and 7.9% one year in the future. That's too aggressive for us to stand by as an actual near-term forecast, but it's an indication of the powerful **risks** that are presently in play.

The language in the minutes seized on by the market was not quite the all-clear signal it might have first appeared to be. To be sure, when the Fed states that "most members thought the end of the tightening process is likely to be near," it is unmistakably signaling an internal perception that the end is in sight. But that's not the same as committing to a **date-certain conclusion** to the cycle. It received little media attention, but the next sentence in the statement clearly seems intended as a cautionary note: "However, members also recognized that in current circumstances, checking upside risks to inflation was important to sustaining good economic performance." The final sentence of the relevant paragraph was a reaffirmation that the central bank remains **data-dependent**: "The need for further policy firming would be determined by the implications of incoming information for future activity and inflation."

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Our take is that, yes, if the economy appears to be **slowing to "trend,"** *i.e.* in the realm of 3% **real growth** as opposed to the 4.5% to 5% that marked the first quarter, accompanied by a **slackening of labor market conditions** and no sign of rising statistical inflation, the Fed will soon be done. It's not at all apparent, however, that those conditions are the ones most likely to eventuate. We see no support for the proposition the economy is likely to slow markedly in the months ahead. The **forward-looking market signals** we watch suggest **growth expectations** remain strong, continuing to support a robust pace of **capital formation**, the mother's milk of vibrant **expansion**. Sustained growth in the 4% range for the remainder of the year appears the most likely outcome. And at 4.7%, the **unemployment rate** is already below the 4.75% that the **FOMC** set out as the low end of its forecast for the full year. We see the rate as likely to continue to trend lower, probably reaching 4.5% in the second half of the year, which is problematic for policymakers who subscribe to the **unemployment/inflation risk tradeoff**.

We have long held to the view that a period of higher core inflation is virtually inevitable, given the Fed's long period of **excessive ease** which has so weakened real dollar purchasing power as indicated by sensitive market price indicators such as gold, **broader commodity indices** and **foreign exchange**. In yesterday's CPI release, the first inklings of factors that could lead to a sustained rise in core inflation were visible. Critically, the category of **"owners' equivalent rent"** saw its biggest rise in more than five years, at 0.4%. This component, which constitutes 23% of the core index, has been held down during the **residential real estate boom** of the past several years, as the investment appeal of **owner-occupied housing** -- fueled by historically low **mortgage rates** -- held rents in check. Further, some element of that component is based on **Bureau of Labor Statistics** formulas, which depend critically on the level of **interest rates**. Now, with rents rising as the housing market cools-- and higher interest rates beginning to move BLS's calculations formulaically higher -- this has become an element of the index contributing to higher, rather than lower, reported core inflation.

Meanwhile, the seemingly inexorable rise in the dollar price of gold continues, with the monetary metal above $640, hitting its highest level since November 1980. No doubt, the gold market has been boosted in recent days by intimations suggesting the Fed's policy process could stop short of reaching an **equilibrium rate**. One of the more **dovish** of the current cast of policymakers, **San Francisco Fed president Janet Yellen**, made her own contribution to the gold rally yesterday when, during an interview on **CNBC**, she dismissed the inflationary message of the rising gold price, asserting that it was due to Chinese demand. Gold's rally to its highs for the day yesterday followed shortly after her remarks.

Bottom Line: Despite the interpretation of the FOMC minutes suggesting the Fed's rate-hiking cycle is nearly complete, we see the central bank as unlikely to call an end to this policy thrust under currently observable conditions. More than anything, the minutes underscore that the Fed remains highly data dependent. Given the absence of indications suggesting that the economy is likely to decelerate significantly, or **job growth** ease noticeably, we see the process as unlikely to conclude in the near term. Moreover, the Fed is highly unlikely to put an end to the rate hikes in the face of any hint of a rise in core inflation, as was suggested by yesterday's CPI data. The most dovish we can force ourselves to be is to envision, perhaps, a short pause for one or two FOMC meetings. We continue to see the funds rate reaching 5.5% by this fall, and don't rule out a 6% rate before year end. TM