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Lesson Learned?

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Will the blowback from Bernanke's pause talk keep the Fed from damaging its credibility?

Whether or not **Ben Bernanke** intended to signal last week that **the Fed** was considering shutting down its push to **monetary equilibrium** despite the risk of **higher inflation**, that's clearly the message received by the markets. Since Bernanke's **congressional appearance** last week, the erosion of **dollar purchasing power** against both **gold** and **foreign exchange** has accelerated, with gold up another 5% to around $670, a level last seen in 1980, while the **trade-weighted dollar index** is down nearly 2%. The **yield differential** between **nominal Treasuries** and their **inflation-indexed counterparts**, widened by more than 10 basis points.

At 270 bps, the **TIPS spread** is approaching levels seen just prior to the Fed beginning the reversal of its **hyper-accommodative stance** nearly two years ago. Since early this year, the **benchmark 10-year Treasury yield**, at 5.15%, is up by about 80 bps. Half of that has been explained by a rising **inflation premium**, as seen in the TIPS spread rising from 230 to 270 bps. Half of this spread widening has come in the past month, amid a belated reawakening to inflation risk by a **credit market** that had been content to tell itself that inflation was all but consigned to the scrap heap of economic history.

Our new **Fed chairman** is known to track the TIPS spread. Indeed, its quiescent performance all these months had been a key indicator shaping Bernanke's view that **inflation expectations** remained **"contained."** The pop in the spread after his testimony last week may have been what compelled him, if we are to accept the account of **CNBC's Maria Bartiromo**, to tell her that he felt the market misread his testimony, and that he found the response "worrisome." According to our sources, it is Bartiromo who got it wrong. But be that as it may, in an important sense, it's difficult to see why Bernanke would believe the market got it wrong in the first place. According to the most direct reading of Fed expectations, **fed funds futures**, the market simply read Bernanke's testimony as pushing back by an **FOMC meeting** or two the likely arrival of a 5.25% funds rate -- from June, to August or September. Clearly, that's consistent with his statement before the **Joint Economic Committee** that the FOMC "may decide to take no action at one or more meetings in the interest of allowing more time to receive information relevant to the outlook."

But if Bernanke is unhappy with the response of **market price indicators** such as gold, forex and TIPS, it could serve as an important object lesson in monetary reality. Yes, the remark about the possibility of **pausing** was carefully hedged with assurances that a potential **break from rate-hiking** would not necessarily mean an **end to the process**, and that policy would remain **"data dependent."** In so doing, he likely thinks he went as far as he could to inoculate the central bank against worries that it will end this cycle prematurely. In his **demand-based output-gap model**, if the data show a **slowing in growth**, it would be tantamount to an **easing of inflation pressures**, allowing the Fed to safely call a pause -- and eventually an end -- to the

rate-hiking process. In the real world, however, inflation is caused not by strong growth but by an excess of **monetary liquidity** relative to demand. If the Fed ends the **policy normalization process** satisfied that growth has slowed sufficiently but before the **liquidity excess** -- as indicated by the market price indicators -- is withdrawn, it will sanction a significant inflation error. That is the risk the markets have been communicating since last Thursday's hearing.

In the final analysis, however, we see scant evidence to support the notion that **economic performance** is likely moving toward a significantly less robust posture. For the next several policy meetings the Fed is thus unlikely to have an opportunity to easily contemplate a pause. The only scant evidence of a slowdown in economic activity that the FOMC is likely to have would be some deceleration in the **housing market**. At interest rates already somewhere in the general ballpark of "normal," that may be enough for the committee to justify pausing briefly on the grounds of a **"do no harm" principle**, relying on its presumed credibility to cause markets to trust that any inflationary consequences of a pause could be quickly addressed later. But for a central bank, there is no surer way to lose credibility than to overly rely upon it.

In fact, indications of an uptick in the deeply lagging **official inflation indexes** will make it all the more difficult for the Fed to assure the markets of its commitment to **price stability**. With the 0.3 increase in the **core PCE deflator** reported earlier this week, the Fed's favored inflation indicator is now running at 2% on a year-on-year basis, the top end of the central bank's **"comfort zone."** On a three-month annualized basis, it's running at a rate of 2.5%. This **statistical inflation** simply reflects the **feed-through effects** of the Fed's highly accommodative stance of the past several years, and there's nothing current policy can do to preclude the eventual surfacing of these pipeline pressures. All the same, it' a good bet that the Fed will not choose to alter its policy course during a period when the price indexes are rising.

Bottom Line: Ben Bernanke's hints about a potential pause in the Fed policy process have received a resounding thumbs' down from the most sensitive market indicators of dollar value. While the new Fed chairman may think he was misread by the markets, we believe there is an important lesson for him to be learned from the market response: contemplating the possibility of an end to this cycle prior to reaching policy equilibrium would be a costly mistake. As we have noted, even as the Fed has been raising rates, it has continued to lag further behind equilibrium. Ultimately, this likely will require the Fed to do more to catch up than it currently anticipates and more than markets are currently priced for. TM