TrendMacrolytics

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Coming Home to Roost

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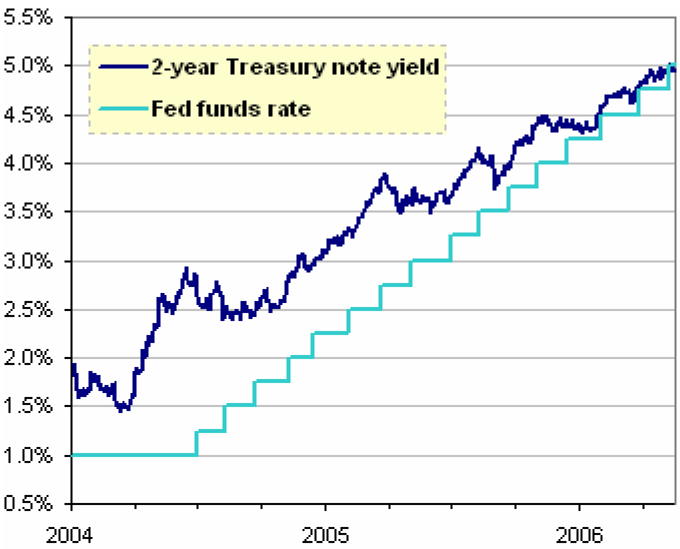
New inflation awareness means that the Fed can do more sooner, and avoid doing too much later.

It's difficult to resist the temptation to say "we told you so," in light of abundant recent confirmation of our insistence over many months that **the Fed's** prolonged posture of **excessive accommodation** would inevitably beget **higher core inflation**. Despite denial for so long by seemingly **benign readings** from the deeply lagging **statistical inflation indexes**, bolstered by the Fed's boilerplate assurances that inflation influences remain **"contained,"** the consequences of the central bank's **policy posture of staying too easy for too long** are now coming home to roost.

Although **equity markets** have been hit hard by the implications of this dawning inflation reality, in an important sense the timing could end up being propitious. Without some credible evidence that inflation wasn't as quiescent as the Fed wanted to believe, there was at least a chance that policymakers would be tempted to **pause**, leaving them even further **behind the curve** in reaching **monetary equilibrium**. As it stands now, however, the Fed likely will have little choice but to continue **hiking rates** for the next several **FOMC meetings**. We think that at some point in the range of 5.5% to 6%, policy will likely get to **neutral** and begin quelling the inflationary impulses which have actually intensified recently amid **speculation** that the Fed was poised to prematurely suspend or halt the rate-hiking process. By serving as a wake-up call, the recent inflation data could preclude a more damaging Fed inflation error that would have ultimately precipitated an **economy-crushing rate-hiking panic**. We don't rule out the possibility that the unavoidable surfacing of price pressures embedded by past Fed accommodation could yet compel a rate **overshoot**, posing a significant threat to this **expansion**. On balance, though, those risks have been reduced by the latest inflation data which should have the Fed doing **more sooner** and avoiding the need to do **too much later**. That would suggest that both **stocks** and **bonds** have misinterpreted the present opportunity -- stocks by over-reacting to the downside, and bonds by not reacting enough

Yesterday's **CPI** release, showing a second consecutive monthly jump of 0.3% in the core reading, was undoubtedly an eye-opener at the Fed. Yes, one month of data can be readily discounted as an **outlier**. In fact, it would be a stretch to suggest that two data points in a monthly series establish a definitive **trend**. It is apparent, however, that conditions which had been restraining the core rate are no longer doing so, and that's not likely to change soon. In particular, the **residential real estate boom** was accompanied by a softening of the **rental housing market**. This had a depressing effect on the **"owner's equivalent rent"** component of the CPI, which has a weighting of 23% in the core index. Now, with residential real estate **cooling**, the rental market is picking up, and owners' equivalent rents -- up 0.4% in April -- have risen at an annual rate of 4.5% the past three months. Some commentators yesterday suggested that because the Fed has been concerned primarily about the **pass-through** of **higher energy prices**, then to the extent that the increase in core inflation has been explained by rent, it should be of less concern for the Fed. But the rental calculation in past months was a **statistical distortion**, biasing the core rate lower (see "Core Inflation Not as Low as It Looks" November 16, 2005). With this component no longer holding the rate down, the current core rate -- up 3.2% at an annual rate the past three months -- is a more accurate reflection of inflation reality.



Credit markets have been extremely volatile confronting an environment in which a number of assumptions are now subject to great uncertainty, but we see bonds at these levels remaining highly vulnerable both to heightening inflation awareness and the Fed's likely response. Since late March, the **10-year Treasury yield** is up about 40 basis points on net, with about half of that explained by a higher inflation premium reflected in the **spread between nominal and inflation-indexed bonds**. The other half is a rising **real rate**, which has generally corresponded with the **short end of the curve** being pushed higher by **Fed expectations**. The short end, however, appears to be clinging to the most optimistic assessment of the Fed outlook, with the **2-year note** currently yielding a few basis points less than the Fed's current 5% **target rate**. As seen in the chart above, showing the 2-year against the fed funds rate over the course of this rate-hiking cycle, this **wishful thinking trade** has sporadically appeared since the Fed got the funds rate to 4.25% late last year. Less than two weeks prior to the Fed's May 10 move putting the target rate at 5%, the 2-year was yielding 4.87%. In any case, it seems apparent that as the short end responds to the Fed's very likely determination to continue moving rates higher, **longer maturity yields** will rise in train, irrespective of the **inflation premium**. And with inflation expectations on the rise, it's unlikely that the **yield curve inversion** seen earlier this year will be repeated as the market adapts to the likelihood of further increases in the short rate target, at least not before the Fed gets the funds rate to neutral.

BOTTOM LINE: From the market's perspective, the prospect of rising core inflation has moved from the status of possible but unlikely to clear and present reality. Among the implications of this scenario shift which helped precipitate yesterday's equity market downdraft, the notion of the Fed taking an early opportunity to pause in its rate-hiking exercise is probably off the table. In fact, though, we believe that in the longer run, the wake-up call on inflation is actually more positive for the economy and stocks than a Fed pause would have been. At this point, we see year-on-year core inflation topping out in a range around 3%. Though significantly higher than recent experience, historical experience suggests that that pace of price-level growth for a relatively brief period would be economically tolerable and probably wouldn't bring about a draconian Fed response. But had the Fed suspended the rate hikes, its target rate would have been left at below equilibrium levels, which would have made an even larger inflation breakout all the more likely. That unavoidably would occasion an aggressive Fed response, putting the economy at extreme risk. In other words, the sooner the Fed gets to neutral the more likely it is that the current expansion can be sustained. TM