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FED SHADOW

Bernanke Arrives

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An inflation-aware Fed will do the right thing for the right reason -- but still may get it wrong.

With gold falling nearly $20 and the dollar rallying off 13-month lows, Fed Chairman Ben Bernanke's restated commitment to inflation vigilance yesterday was a much-needed antidote to the growing impression that the central bank might veer off its course to monetary equilibrium, led astray by all the hype suggesting the economy is heading toward a significant deceleration. Even while acknowledging the signs of a moderation in the pace of expansion, Bernanke left no doubt that inflation is the first priority, declaring the recently elevated readings from the core price indexes "unwelcome developments."

But as welcome as was Bernanke's effort to restore a sense of reality about the policy outlook, the market price indicators to this point have done little more than retrace their weaker-dollar swing in the wake of Friday's below-expectations payroll jobs number. Yes, the futures markets have upped the odds on a 25 basis point rate hike late this month to 80% from less than 50% prior to Bernanke's speech (and about 75% just before Friday's jobs report), but they show only a small chance of any further action before the end of the year. Essentially, the market is resorting to its familiar "one and done" bet, after accepting that a move to 5.25% is virtually inevitable. In fact, the Eurodollar futures curve is now showing a better-than 60% chance of a rate cut by September 2007, the highest since the yield curve went into inversion earlier this year. This rate cut bet in long-dated futures explains why the curve has again flattened to the extent it has, and is now on the cusp of inverting again after steepening to as much as 20 bps in mid-May.

Update to strategic view
FED FUNDS: A 25 basis point hike at the June FOMC meeting will not be the end of this cycle. Bernanke's renewed public commitment to damping inflation expectations means that the Fed is still not "one and done." **BONDS:** Bonds are mispriced not for "one and done," but a "one, pause and cut" scenario that will not happen. We reiterate our longstanding short call on long bonds. **COMMODITIES:** The inflation scare that drove commodities to record highs last month is over. That was the top. **US DOLLAR:** Similarly, absent a major tightening error by a foreign central bank, the dollar has seen the lows.

It seems hope springs eternal for the bond bulls, but we find a dearth of analytical support for the parameters of their expectations. In his remarks yesterday, Bernanke's focus of concern was the current core inflation data, eliciting his pledge that the Fed would be "vigilant to ensure that the recent pattern of elevated monthly core inflation readings is not sustained.'' It's critical to recognize, however, that the current inflation indexes reflect the lagged effects of the Fed's easy money stance going back as much as three years. Notwithstanding Bernanke's vigilance, there's nothing he or anyone else can do about the inflation that's been embedded in the system by past policy. The most the Fed can do now is get policy to equilibrium as quickly as possible to keep additional inflationary influences from being piled atop those now feeding through the system. But to the extent Bernanke conceives the Fed's present task as keyed to the rising core inflation data now being reported in lagging official indexes, it certainly doesn't bode well for any bet that the Fed's next move is likely to be its last.

It also may not bode well for prospects that the Fed can conclude this rate-hiking cycle before it overshoots and puts the expansion at significant risk. If Bernanke is suggesting that the Fed is committed to chasing rising core inflation indexes with higher rates, it could be a long and rocky road. More likely, though, Bernanke -- as well as other senior Fed officials -- understands that the price indexes are deeply lagging, but feels compelled to take a hawkish stand vis-à-vis the data as a means of keeping inflation expectations from coming unhinged. In all of his public statements in four months as chairman, Bernanke has consistently put expectations management as the lynchpin of his policy approach, and he said nothing yesterday calling that into question. Still, ensuring that expectations remain well behaved in the face of what is likely to be a period of rising statistical inflation cannot be done with smoke and mirrors. Further tightening action -- more than the market now expects -- will be required. The open question is whether Bernanke and the Fed will show enough dexterity to get policy to equilibrium without incurring an economically destructive overshoot.

BOTTOM LINE: Ben Bernanke's speech yesterday will likely come to be seen as a turning point in his early tenure as Fed chairman, putting the markets on notice that he sees his job as first and foremost to keep inflation under control. Unfortunately, however, it now seems apparent that the Fed's over-long stay in a highly accommodative posture and too-slow trek to restore policy neutrality will produce considerably more inflation than Bernanke was bargaining for at this stage in his chairmanship. But those are the cards he's been dealt, and the question now is how he plays them. TM