TrendMacrolytics

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Bernanke on the Hill

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The Fed chief may hope the data will allow the rate hikes to stop, but there's one more coming.

Taking it at face value, there is certainly plenty to be troubled by in Fed chief Ben Bernanke's congressional testimony this week. The Fed's new mantra, first unveiled in last month's FOMC statement -- that slowing growth "should help to limit inflation pressures over time" -- is pure neo-Keynesian, output gap pap, clearly discredited by the historical record (see "On the June Employment Report" July 7, 2006). In his references to oil and other commodities, rising prices were treated entirely as giving rise to exogenous inflation risks from a cost-push perspective, rather than reflecting the excess dollar liquidity resulting from the Fed's still-accommodative policy posture (see "The Middle East, Oil, Gold and the Fed" July 14, 2006).

Update to strategic view

FED FUNDS: Macro and inflation data won't bail Bernanke out from having to do at least one more rate hike in this cycle, to 5.5% at the August FOMC meeting.
US STOCKS: This week's successful test of the lows is encouraging that our characterization of recent weakness as a buying opportunity was correct. But we are staying on cautious alert until we see more definitive evidence that the Fed is strong and credible enough to rein in inflation expectations without draconian rate hikes in the future.
US BONDS: The best case for bonds is that the Fed will stop at 5.5% -- but even if it does, there will be a long plateau there, for which the present inverted yield curve is ill-prepared.

[see Investment Strategy Dashboard]

If Bernanke and his colleagues don't understand that remaining too easy for too long has already embedded significant inflation pressures which will inevitably feed through the badly lagging price indexes regardless of whether or not growth slows as much as they expect, the possibility of damaging policy error remains real. One saving grace, though, is that the inflation reality is finally becoming visible in the core inflation data, with yesterday's core CPI report coming in at 0.3% for June, the fourth such print in a row. That puts core CPI at an annual rate of 3.2% so far this year, and 3.6% in the past three months. These rates are likely to be sustained for the foreseeable future -- before year-end, 12-month core CPI could easily be above 3% for the first time since 1995. Another saving grace is that Bernanke is not incognizant of these risks. When Senator Robert Menendez asked Bernanke yesterday to name the "most significant threat to economic expansion," Bernanke didn't mention the cooling housing market, high energy prices, or the lagged effects of past Fed rate hikes. Instead -- in our mind, quite correctly -- he cited inflation and the Fed's potential reaction to it:

> "Well, I think that the risk that we are considering -- and again, it's just a risk, that inflation might move up and might force us to be more aggressive, which we don't want to do, because we hope that inflation will stay under control and come down as we expect it to -- I think that is a risk."

Some of today's press reports suggest that Bernanke was essentially downplaying the current inflation data based on his assumption that moderating growth will soon put core inflation on a downward track. The Fed's "central tendency" forecast included with the testimony, however,

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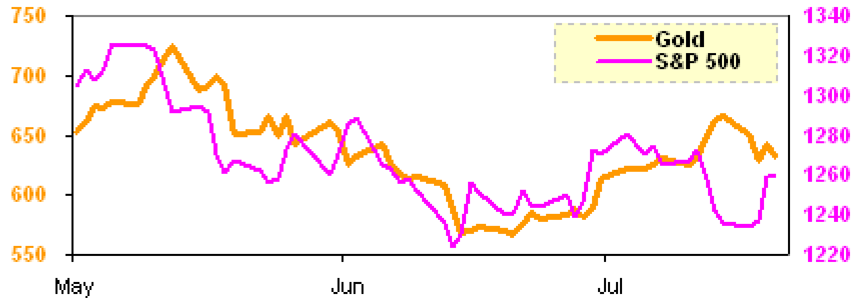
implies a 2.5% real GDP growth rate for the remainder of this year. If the economy runs stronger than that, and inflation continues to print higher -- both of which we expect -- the Fed will have little choice but to continue the tightening process. We continue to believe that if this is done expeditiously, it will be a good thing for the economy and the stock market. Bernanke himself suggested much the same thing in response to Senator Jim Bunning's pointed observation that equity markets have fallen since the new Fed chair took office -- especially since his self-confessed "lapse of judgment." Bernanke said,

> "...I think the best thing we can do...to help get the market up would be to go toward our mandated goals to create stable growth and to keep inflation low. And that's what we intend to do ...If we had stopped raising rates at 4.75 or 4.5 percent, I think there would be a lot of concern in the market, in the economy about inflation at this point."



BOTTOM LINE: Such concerns have been uppermost in our minds last week, as equities fell to test their recent lows at the same time as gold -- the most inflation-sensitive of all market prices -- rose to test its recent highs. For us this was a case of "be careful what you wish for." Early last week we had noted the lockstep trading relationship over the last two months between the S&P 500 and various indicators of inflation expectations -- most notably, gold (see "Inflection Point Deflected" July 11, 2006). Our thesis was that investors have been treating stocks as nothing more than a "carry trade" or "inflation play," and we looked forward to a divergence in which a salutary diminution of inflation expectations would drive gold lower and stocks higher. We got our divergence, all right, but it was in the opposite direction -- stocks down, gold up -- suggesting that the market was looking for exactly the "most significant threat" that Bernanke spoke of to Senator Menendez: an inflationary breakout followed by a recession-inducing Fed response. Even though gold rose yesterday in response to Bernanke's testimony, stocks rose more. In combination with the stiff drop in the gold price over the prior three days, stocks and gold have pretty much gotten back into lockstep with each other, suggesting that a crisis has passed, at least for the moment. The kind of divergence we are looking for -- stocks up, gold down, in which a definitive and credible Fed commitment to inflation vigilance blunts inflationary expectations at the same time as it bolsters growth expectations -- remains elusive.

Yesterday's testimony, if nothing else, shows that Ben Bernanke does not wish to be especially definitive. As he might want to believe that conditions will soon allow him to put an end to the the present cycle of rate hikes, he also realizes that he doesn't know enough yet to make a definitive declaration in that regard. And perhaps after five rocky months in his new office, he has no doubt learned that being definitive is hazardous to one's career health, especially when that which one is definitive about changes so frequently. So for now, Bernanke will have to be definitive with actions, not words. That is less than ideal, because a strong and credible Fed can usefully substitute words for action, by inspiring confidence in the marketplace that will enhance the demand to hold dollars, and thus at the margin reduce inflationary pressures. An uncredible Fed does just the opposite. We expect that continuing clear evidence of inflation risk, and lack of evidence of a substantive economic slowing, will compel the Fed to raise rates to 5.5% at the August FOMC meeting. We will continue to look to market-price indicators such as gold to tell us whether that will be enough to end this rate-hiking cycle with inflation risk well contained. The expansion, and the stock market, remain hostage to these contingencies. TM