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FED SHADOW

Surprise on the Doveside

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The Fed dug itself deeper in inflation denial yesterday, which raises the price the economy will have to pay tomorrow.

Update to strategic view

FED FUNDS: Tuesday's FOMC statement committed the Fed to a dovish posture that will deepen the market's conviction that the rate-hiking cycle is over. But mounting inflation pressures will inevitably force the Fed to resume rate hikes later this year, and they will come faster and harder than anyone now expects.

[see Investment Strategy Dashboard]

The Fed must have believed that a decision to keep rates on hold for the first time in more than two years required that it evince less concern about inflation prospects -- so yesterday it actually adopted a more dovish posture regarding the policy outlook. Resigned to the reality that the Fed, in a misapplication of recent economic data, was highly likely to take no action yesterday, we held out some hope that it would fashion the post-meeting statement to at least express heightened ongoing concern about inflation risk. This would have signaled that a quick end to the pause was at least as likely as its continuation. Instead the FOMC has essentially taken the view that further rate hikes will be required only if its current assumptions are countered by unfolding economic evidence. This approach only deepens our concern that policy is now fated to fall even further behind the curve, increasing the risk that ultimately the catch-up process is likely to entail considerable pain (see "March to Folly" August 4, 2006).

"Inflation pressures seem likely to moderate over time, reflecting contained inflation expectations and the cumulative effects of monetary policy and other factors restraining aggregate demand," the statement yesterday said. Following the previous meeting on June 29, the FOMC said that although moderation in growth of aggregate demand "should help to limit inflation pressures over time, the Committee judges that some inflation risks remain." While further down yesterday's statement acknowledges that "some inflation risks remain," the change in emphasis is clear. Moreover, the previous statement ended with the assurance that "the Committee will respond to changes in economic prospects as needed to support the attainment of its objectives." That sentence, which was interpreted as a pledge of continued vigilance, was dropped from yesterday's statement.

The Fed's deliberations were no doubt made more difficult yesterday by the second quarter productivity data. It showed non-farm productivity rising only a sub-par 1.1% on an annual basis in the quarter, down from 4.3% in the first quarter. And it showed unit labor costs accelerating at a 4.2% rate during the second quarter, and now running at a near-six-year high of 3.2% on a four-quarter basis. In the June statement, the FOMC cited "ongoing productivity gains" that "have held down unit labor costs" in its reasoning that inflation remains an insignificant threat. But even after yesterday morning's data stripped that rationale away, the Fed was not to be deterred. Yesterday's FOMC statement simply dropped any mention of productivity or labor costs.

Meanwhile, we note that despite the Fed's boilerplate assurance of "contained inflation expectations," the sensitive market prices we monitor including gold, foreign exchange and broad commodity indexes suggest expectations are hardly "contained" (see "Bernanke's Quagmire" August 7, 2006). Above $640, gold has now retraced fully half the decline from $720 to $560 seen in May and June when an apparently vigilant Fed appeared on its way to restoring confidence in the unit of account. It's worth noting as well that the TIPS spread -- the one market indicator that we know Fed chief Ben Bernanke follows closely -- has widened by some 13 basis points from its recent lows around 252 bps in mid-June. It was the rise in this spread to 272 basis points in May that apparently compelled Bernanke's shift to more hawkish rhetoric. Following today's dovish tilt by the FOMC, the TIPS spread popped higher by 3 bps, and is now within 7 bps of its May highs.

The reasons for Richmond Fed chief Jeffrey Lacker's dissent in yesterday's decision won't be known until the FOMC meeting's minutes are published next month. But perhaps he was uncomfortable with the Fed's increasing denial of inflation risk. Lacker believes the Fed's "highest priority" is "keeping inflation low," and prides himself on the Fed's "ability and willingness to follow through on our announced intentions." Perhaps he feels as we do -- that yesterday the Fed failed to follow through on Ben Bernanke's tough anti-inflation talk of May and June (see "Bernanke Arrives" June 6, 2006). Lacker supports Bernanke's "inflation targeting" concept, and has advocated that the Fed announce a formal policy target of 1.5% annual growth in the core personal consumption expenditures deflator. While Ben Bernanke only saw in the recent second quarter GDP report that the economy is "moderating," perhaps Lacker saw his inflation target printing at nearly twice his preferred rate (see "Data Dependent" July 27, 2006).

BOTTOM LINE: Of the Fed's remaining rationales for minimizing inflation risk, one -- that a moderating economy will naturally slow inflation -- is based on academic theory refuted by historical evidence; and the other -- that inflation expectations are "contained" -- is based on claims contradicted by any quote-screen. The more the Fed leans its credibility on such thin reeds, the more difficult it will be to effectively respond when inflation pressures inevitably mount to levels that can't be ignored. Later this year the Fed will surely be drawn back into its aborted rate-hiking regime. Then it will be even further behind the curve than it is today, and its credibility will be even more diminished. The rate hikes will come fast and hard, and the landing will not be a soft one. TM