

MACROCOSM

Dovish Day

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Renewed conviction that inflation is dead hangs on a thread less than a hundredth of a percent thick.

It's another good day for the inflation doves, as the latest consumer price release was reported as showing core CPI up 0.2% on the month, in line with expectations and giving the chatterers fodder to insist that a "benign" inflation environment prevails. The raw data, however, show that the increase came in at 0.242%. Less than another hundredth of a point higher and it would have been reported as up 0.3%, and the response would no doubt have been considerably different. In this climate the difference between 0.2% and 0.3% seems momentous, but for a statistical aggregate as massive and inherently imprecise as the CPI, it beggars the imagination that such small differences in a monthly data point could account for such a wide disparity in interpretation. Consider that 0.242% amounts to an increase of 2.9% at an annual rate, while 0.252% would come to 3.1% annualized.

The purportedly benign data, meanwhile, don't obscure that the trends clearly continue to point higher. Year-over-year, core consumer prices are rising by 2.8%, up from less than 2% a year ago and highest in more than 10 years. The recent acceleration, moreover, is even more clearly seen in the six-month annualized pace now running at 3.4%, up from 2% last November. While the past two readings have slowed from the 0.3% monthly pace of the previous four months, short-run month-to-month variability in the context of an overall trend are not unusual in the statistical price indexes. We see the process of the price level catching up for the Fed's excessively easy posture the past three years as still in its fairly early stages, and expect to see the 12-month core rate running at 3.5% to 4% within the next year.

Of course, even under the least threatening interpretation, the inflation data has still been running above the 2% top end of the Fed's so-called "comfort zone," and has been for the past year. We are assured by the Fed, however, that this is a short-term phenomenon, and that inflation pressures are sure to subside, in keeping with its belief that the pace of expansion is now slowing to a "below trend" rate of 2.5% or less. The central bank's forecast, however, is unlikely to be borne out on either count. Despite widespread sentiment, there is a dearth of evidence to suggest that any considerable economic slowdown is underway. But even if one were underway, the Fed's conception of inflation as a real growth phenomenon is a product of its Phillips Curve/output gap worldview, which time after time has proven to be fallacious. In many ways, the current policy setting can be seen as equal and opposite to the situation prevailing from the late 1990s until the early part of this decade. At that time, the Fed was convinced that an economic boom was by definition inflationary, and engineered a deflationary tightening that torpedoed the economy and put an end to one of most vibrant eras of wealth

Update to strategic view

FED FUNDS: No change at next week's meeting, but it's better than 50/50 that the Fed will resume hiking rates in October.

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creation and capital formation in the nation's history. Now, it mistakenly holds that the hazy specter of a growth slowdown assures that evidence of rising inflation can be written off as little more than a fleeting blip.

In the final analysis, the result of this inflationary Fed error is likely to be similar to the previous deflationary one, putting at serious risk the sustainability of the currently vibrant expansion. Having essentially written off the current inflation uptrend, the Fed will be compelled to resume the rate-hiking process when it can no longer deny the data showing that the economy remains robust. Although from our perspective the evidence of that reality is already ample, the Fed is some distance yet from acknowledging that, and can be counted on to maintain its pause at Tuesday's FOMC meeting.

BOTTOM LINE: A seemingly friendly CPI reading today has given markets another opportunity to satisfy themselves that inflation is yesterday's news and the Fed is out of the picture. Not likely. Although the data is not irrefutable enough yet to force the Fed out of its pause posture at next week's policy meeting, the evidence that policymakers have bet wrong on the growth front could well force a resumption of rate hikes by late October. And as the rising inflation reality becomes increasingly clear cut in the months ahead, we see the Fed as nearly unavoidably being put in the position of having to enter an aggressive catch-up mode, inevitably leading to an overshoot with what is likely to be significantly deleterious economic consequences. 