TrendMacrolytics

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Testing Bernanke

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The bond market is ignoring Bernanke's hawkish protestations, because for now it's nothing but talk.

We have to assume that in opting to address the economic situation after more than four months of silence on the subject (see "Indian Summer" November 21, 2006), Fed chief Ben Bernanke sought to deliver a message that he felt the market needed to hear. It's clear what he had in mind, telling his New York audience that core inflation remains "uncomfortably high," defining the issue at hand as whether to resume raising rates, not whether to cut them. That was underscored by his assertion that "A failure of inflation to moderate as expected would be especially troublesome." There was nothing in his generally upbeat economic assessment that would imply a similar perception of downside risk that could occasion a shift to rate cutting.

Update to strategic view

US BONDS: Bonds are ignoring Ben Bernanke's tough talk on inflation because his hawkishness is belied by the Fed's present pause, which is being interpreted as a harbinger of rate cuts to come. As the dollar stays weak, and inflation and growth come in stronger than expected, the case for rate cuts will become increasingly more remote. It is probably already near impossible that long bonds could much extend their present inversion to the funds rate, or hope to maintain it for long.

[see Investment Strategy Dashboard]

But perhaps this is a market that has taken the measure of Bernanke in his first ten months in office and already sees good reason to doubt that his words necessarily translate into action. This is, after all, the rookie Fed chairman who, after getting smacked by the markets last spring for signaling a possible dovish turn in policy, put on a rhetorical display of vigilance for several weeks -- only to confirm the initial dovishness by early summer, setting the stage for the ill-advised pause that began in August. Such missteps so early in his tenure could leave a lingering impression, ultimately requiring a heightened demonstration of forcefulness to establish his authority. Clearly, Bernanke's attempted nod toward hawkishness yesterday fell on deaf ears, with interest rate futures actually extending their bet on the extent of expected Fed *ease* next year, and the 10-year Treasury yield dropping another few basis points, to 4.5%.

The latest jump higher in gold and down in the dollar can also be seen as rooted in questions about Bernanke's credibility. We trace the proximate cause of this latest dollar weakening episode to reports around Thanksgiving that Bernanke would be accompanying Treasury Secretary Henry Paulson on his trip to China next month. With US complaints about China's supposed "manipulation" of the yuan to maintain a favorable exchange rate expected to be high on the agenda, who better to have on hand than the Fed chairman to remind the Chinese that such currency "manipulation" could be a two-way street? We doubt that such speculation would hold much sway were the Fed not still in an accommodative posture, with Bernanke's inflation-fighting credentials already facing considerable skepticism. Under such conditions, though, even seemingly innocuous events could represent a tipping point.

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With Bernanke, there is also an added element of uncertainty regarding his appreciation for the signaling properties of such market indicators as foreign exchange and commodities. His model appears to give little weight to these market prices; in his speech yesterday, he made no mention of the dollar's recent weakening. During a period of extended dollar weakness in early 2004, in the Fed's hyper-accommodative policy phase, Bernanke as a Fed governor essentially dismissed the potential inflationary consequences of a weak dollar, citing "the modest weight of imports in the consumers' basket of goods and services" (see "On Bernanke" January 5, 2004). As we noted at the time, Bernanke's rationale echoed assurances made in the early 1970s about the minor inflationary effects of dollar depreciation due to the relatively small share of imports in consumption. Of course, the Fed's dollar devaluations of that decade sparked the worst era of US inflation since the Civil War. The possibility cannot be entirely ruled out that Bernanke could sanction further dollar weakening, oblivious to its inflationary implications. It should be noted that in the nearly three years since Bernanke's remarks downplaying the inflation risk of dollar depreciation, core CPI has swelled from 1.1% to 2.8%.

Meanwhile, with gold having rallied by some $85 from its recent lows at $550 last month, and the dollar at better than 18-month lows against its major currency counterparts, it's clear, as we have maintained, that the Fed has yet to reach monetary equilibrium. As much as the market now doubts his seriousness, more than likely Bernanke will be compelled at some point in the next few months to put his words into action. Although it received far less attention than Bernanke's speech, new Philadelphia Fed president Charles Plosser yesterday gave as good a synopsis of current policy realities as we have seen from a Fed official in quite some time. "Ultimately, broad-based inflation on a sustained basis is a monetary phenomenon," Plosser said. "So, we cannot rule out the possibility that the Fed's stimulative monetary policy during the last five years may have contributed to the rise in core inflation. If this is so, then core inflation will not decelerate to acceptable levels until monetary policy has firmed enough to take out the cumulative effects of the accommodation."

BOTTOM LINE: The credit market's apparent insouciance in the face of clear warnings of potential trouble ahead is likely to have a limited half-life. Although Bernanke's credibility has taken a hit, we expect that he will soon have ample opportunity to reestablish his credentials, and could well leave the market regretting that it ever doubted him. Unfortunately, fully restoring confidence in the Fed chairman and, by extension, the integrity of the unit of account will probably end up requiring an aggressive course of action that could bring significantly deleterious economic consequences. TM