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Chairman Bernanke's Year of Living Dangerously

Thursday, February 8, 2007

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In his second year, Bernanke will have to pay the price for the risks he took in his first.

We were asked on a television program this week to grade Ben Bernanke's first year as Fed chairman -- "A" through "F." Before we get to our answer, let us note that our two most trusted forward-looking inflation-sensitive markets have given him a rather poor grade. After a year on the job, gold is up 15% and the US dollar has lost 5% of its foreign exchange value. By way of comparison, gold rose 23% over the entirety of Alan Greenspan's 18-1/2 years as chairman, and the US dollar lost 17%. In terms of official statistics, Bernanke's inflation performance has been slightly better than Greenspan's. Over Bernanke's first year, the core consumer price index has risen 2.6% on an annualized basis, compared to 3% on average during Greenspan's years. But if Bernanke's inflation rate thus far were to run for 18-1/2 years, the overall price level would rise by 61.7% cumulatively.

Update to strategic view

FED FUNDS: The fourth quarter's growth was a wake-up call for the Fed, which has now had to embark on a process of re-examination of its rosy scenario of moderating growth and falling inflation. Continued fast growth in the first quarter will give no relief. We are on the verge of upgrading our timeline for the Fed's shift from pause back to rate-hiking. We are considering the possibility that the first hike might now come as soon as the May FOMC meeting.

[see Investment Strategy Dashboard]

Bernanke himself is aware that this is an unacceptable level of erosion of purchasing power. The Fed often repeats the hopeful message, as it did in last week's FOMC statement, that "inflation pressures seem likely to moderate over time." Since this is purely speculation, it would seem to be giving Bernanke an "A" in advance of having taken his final examination. And the Fed knows this very well. Fed officials are unanimous and consistent in conditioning their high hopes with caution, saying that today's inflation rates are too high and must come down -- even if it takes higher interest rates to do it. Philadelphia Fed president Charles Plosser's statement to that effect yesterday was especially forceful, and assuredly Bernanke will repeat the same idea in his congressional testimony next week.

Thus it would seem that Bernanke is giving himself a grade of "incomplete" -- which is precisely what we would do. At this point nobody knows for sure whether he will get away with his gambit of holding the funds rate at 5.25% since last August, even as reported measures of core inflation have generally continued to rise. The pause's purpose was surely to ease the severity of the housing cool-off and stem the risk that it would spill over into the overall economy, and perhaps it worked. As the FOMC put it last week, "tentative signs of stabilization have appeared in the housing market." And all along, the overall economy when measured ex of residential investment has only gone from strength to strength (see "On GDP and FOMC" January 31,

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2007). But there's no certainty that the Fed's pause at 5.25% *caused* those good outcomes. Perhaps the inverted yield curve was responsible, for holding down the price of credit in the residential mortgage market. If the Fed had hiked rates another notch or two, who's to say that the long end of the curve wouldn't have just inverted more to make up for it? For that matter, who's to say that the underlying resiliency of an expansion powered by productivity gains, globalization and historically low tax rates on capital wasn't responsible? Or maybe the severity and contagion risk of the housing cool-off was wildly exaggerated in the first place (see "The Housing Cool-off In Perspective" June 22, 2006).

Even if we stipulate that the risk of a housing-led recession was severe and has now passed, and further stipulate that the pause at 5.25% was exclusively responsible for this happy outcome, we're still looking at a grade of "incomplete" for Bernanke. We won't know for some time whether inflation will in fact head lower (as the Fed says it expects), or will remain elevated (as the Fed says it fears), or will move higher (as inflation-sensitive markets such as gold and the dollar are indicating). We expect that it will move higher, and it if does, history won't grade Bernanke kindly -- and he knows it. As Fed governor in 2002 giving speeches about the Fed's "printing press" and "helicopter drops of money," he was the intellectual architect of the dollar liquidity excess that is the source of today's inflation pressures. He feared the risk of monetary deflation, a risk that we judged at that time was non-existent (see "A Deflation Dichotomy" November 18, 2002) -- and he was willing to flood the world with liquidity in order to avoid it. Last year he feared a housing-led recession, and he was willing to leave the world flooded to avoid it. So Bernanke won't be too surprised when reported inflation starts moving higher, and he'll no doubt recognize it as his own creation -- or at least as the price of the insurance policies he was willing to pay.

In our judgment, the risk of deflation in 2002 wasn't worth insuring -- so Bernanke erred by inflating. Ironically, the risk of a housing-led recession in 2005 wasn't worth insuring by Bernanke's own principles as an "inflation targeter," so again he erred. He has argued that the only thing a central bank can do to assure economic growth is to maintain price stability, and that attempts to use monetary tools to deal with non-monetary factors such as the housing market or employment cannot succeed (see "Is Ben Bernanke a Phillips Head?" March 1, 2006). Yet by pausing at 5.25%, Bernanke seems to have deliberately risked price stability for the sake of cushioning the risk of a housing collapse. If fourth quarter GDP is any indication, we can consider it cushioned. So that part of Ben Bernanke that holds to the neo-Keynesian output-gap theory that inflation is causally associated with growth must be getting more than a bit worried. The Fed keeps saying, as it did in the latest FOMC statement, that "the economy seems likely to expand at a moderate pace over coming quarters." But there's simply nothing moderate about it, and no particular reason to expect it to suddenly become moderate. If the fourth quarter could register the kind of growth it did despite almost no improvement in housing, a more than complete reversal of the third quarter's auto output anomaly, a drop-off in business investment and an uptick in inventory liquidation -- then the first quarter is poised to be a barn-burner if there's any improvement in any of those factors, which there is highly likely to be.

BOTTOM LINE: So Ben Bernanke will soon be facing a big test, one that could make or break his grade as Fed chief. The economy isn't "moderating" -- and the fourth quarter showed just how immoderate it really is. Inflation is going to move higher, or at least it isn't going to move substantially lower from its current unacceptably high levels. Unless there is visible worsening in the housing market, the Fed's risk management paradigm will shift its emphasis, moving its focus from the contagion risk of housing to the risk of accelerating inflation. We have been talking about the Fed staying on pause as far as the eye can see, but we are now on the verge of upgrading our timeline for moving from pause back to rate hikes. We are considering the possibility that the first hike might now come as soon as the May FOMC meeting. A new environment of higher inflation and a Fed potentially headed toward restrictive rates will have

profound implications for all markets. There's an inflection point coming, and we know what it looks like -- the critical question now is *exactly when*. TM