TrendMacrolytics

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MACROCOSM

Paper Tiger?

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The Fed is being put on the spot to show it's not all talk.

Update to strategic view
US MACRO: The small correction in the uptrend in reported inflation that began in late 2003 seems to be over. And while 4th quarter growth may be revised lower, it only sets the stage for even more rapid growth in the current quarter.
[see Investment Strategy Dashboard]

Ordinarily, we'd attach little significance to yesterday's $20 gold price rally coming immediately in the wake of an unexpectedly robust Consumer Price Index release. As the most sensitive and forward-looking of the market price indicators, gold -- up about 70% in the past three years -- has been foreshadowing the elevated readings now feeding through to core CPI, among the most lagging and backward-looking of the statistical inflation indexes. CPI, in other words, is in the process of catching up to gold, not the other way around.

So under most circumstances, we'd see the correlation of yesterday's gold price move to a nine-month high just below $680 with the data release as pure coincidence, and look for other explanations. Unfortunately, given the current state of play in the monetary policy realm, and speculation regarding the policy outlook, the correlation is not so easily dismissed. Yesterday's gold rally built steam through the morning amid a stream of market crosstalk suggesting, on the one hand, that the 0.3% bump in core CPI was probably an anomaly, but that even if such readings are sustained, the Fed will be reluctant to respond. The prevailing sentiment was captured by one market player, who described the gold rally as an "indication that the Fed and Bernanke are losing credibility and that the Fed is all talk and no action." The Fed, he added, is "afraid of raising interest rates, but it can't let the market know that. Gold's saying we don't believe you." Fed officials want to "maintain the illusion that they're going to raise rates," but won't because they fear "the economy can't stand it." Such was the mood which brought the 10-year Treasury back from an early post-release sell-off of more than a quarter point, ending the session down just three ticks at a 4.70% yield. And all this came before the mid-afternoon release of the FOMC's January 31 minutes, which were notable primarily for the disclosure that the committee considered dropping its tightening bias but decided against making such a shift "at this time."

While we share much of the skepticism about the readiness of Bernanke & Company to match words with action, we also don't doubt that yesterday's 0.3% print on core inflation got the Fed's attention. To be sure, a core group of policymakers remains content at this point to tell itself that the likely direction of core inflation points lower. But their tolerance for maintaining that forecast in the face of contrary evidence is probably fairly limited. For our part, we have cautioned against viewing the past few months' moderation in the inflation data as a definitive break in the

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trend higher (see "Inflation Mission Accomplished? Not So Fast" November 20, 2006). We will refrain from declaring that a one-month data point necessarily confirms a reassertion of the trend, but it well might -- at the very least it throws a wrench in the wishful thinking of those who saw the uptrend as broken. In the six months from last February through August, core CPI accelerated on a three-month annualized basis from 2.2% to 3.2%. In the fourth quarter, it fell back to less than 2%, but as we have pointed out, such relatively short-run counter-trend moves are not unusual in an overall trend higher. We note a couple of one-time effects that likely explained much of the downshift. One was the break in the oil price surge. While petroleum prices don't directly contribute to changes in core inflation, they affect the cost structures of many industries and can have an important influence on prices. Another apparent factor was the inventory draw-down that the economy experienced in the fourth quarter, which resulted in temporary price cuts in a number of industries. For the most part, these adjustments appear to have run their course, and are unlikely to contribute to further significant downward pressures on the price indexes.

As for the notion that concern about the strength of the economy will restrain Fed action, we continue to believe that growth will actually surprise the Fed on the high side, and will end up being a factor contributing to a resumption of the rate hiking exercise. A few recent indicators have again put a damper on growth sentiment, but we see little to arouse much concern. The first revision to fourth quarter GDP is due next week, and is likely to show a fairly sharp reduction from the initial estimate of 3.5% growth. A large and unexpected decline in December wholesale inventories is likely to be one of the biggest factors pulling the growth rate down to about 2.5%, which is likely to arouse all the usual noise about the economy going into a tailspin and provide some short-lived solace to the bond bulls. Don't fall for it. The inventory correction, which has also contributed to sub-par manufacturing production in recent months and a pause in business fixed investment activity, is probably over. The ISM inventory index last month fell to its lowest levels since the immediate aftermath of the 2001 recession, but as a result it appears that inventories have become lean again, with inventory/sales ratios declining after moving higher for a number of months. From this point going forward, inventories will probably be a net plus for growth, and a turn in this cycle is likely to be accompanied by a return to growth in manufacturing and capital spending.

BOTTOM LINE: With federal tax revenues continuing to run at double-digit year-on-year growth rates and already tight labor markets showing signs of further tautness, we find it difficult to believe that the Fed would choose to remain on the sidelines for fear of the economic consequences in the face of clear inflationary danger signs. The Fed, however, has gone a long way toward inviting such challenges to its credibility over the last several months first by ill-advisedly going on hold, and then following that with a string of seemingly hawkish statements that are coming to sound increasingly hollow. We continue to believe that at some point the Fed will be left with no choice but to return to tightening mode, but growing doubts about its inflation-fighting credentials could make its task all the more demanding when that time comes, forcing it to undertake more aggressive and potentially destructive action. TM