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FED SHADOW

The Bernanke Awakening

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The Fed chief's dollar talk is not just talk. It's a call to action.

Update to strategic view
FED FUNDS: Bernanke's remarks about the importance of supporting the dollar are not just talk, but a prelude to action. We think a first funds rate hike could come as early as August, with as many as three hikes by year-end.
[see Investment Strategy Dashboard]

The consensus view is that Ben Bernanke's remarks this week -- signaling that the Fed is alert to the consequences of dollar weakness -- were intended to put a floor under the dollar without having to make good on the rhetoric with an actual policy shift, at least not anytime soon. According to this interpretation, the Fed chief was engaging in "open mouth operations" so as to guard against further dollar weakness forcing the Fed's hand and compelling a near-term tightening response. Our view is that with the Fed's credibility already in question coming out of the latest excessively indulgent easing exercise, Bernanke would not have raised the issue unless he was prepared to follow up with policy action in the foreseeable future.

In the world of central banking, statements like the one Bernanke made this week are not given lightly. The Fed in recent decades has largely upheld the tradition of deferring to Treasury on currency matters, so Bernanke's decision to speak on the dollar has to be considered to have significant policy implications. "We are attentive to the implications of changes in the value of the dollar for inflation and inflation expectations and will continue to formulate policy to guard against" those risks, Bernanke said on Tuesday, "including the risk of an erosion in longer-term inflation expectations." He added: "Over time, the Federal Reserve's commitment to both price stability and maximum sustainable employment and the underlying strengths of the U.S. economy -- including flexible markets and robust innovation and productivity -- will be key factors ensuring that the dollar remains a strong and stable currency." At the same time, he noted that "inflation has remained high," and suggested that a "significant upside risk to inflation is that high headline inflation, if sustained, might lead the public to expect higher long-term inflation rates, an expectation that could ultimately become self-confirming."

In the initial market response to those remarks, the price of gold fell more than $15 to below $875, the dollar rallied to nearly $1.54 against the euro, bonds sold off, with the 10-year Treasury yield breaching the 4% level, and interest rate futures priced for a growing chance of as much as 50 basis points in rate hikes by year end. Those moves, however, were largely reversed before the end of the trading day, as the analysis took hold that Bernanke's remarks were simply an exercise in jawboning, without policy substance. Yesterday, though, the markets

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had a sudden reappraisal of that interpretation when, in another speech, the Fed chairman declared that inflation, averaging 3.5% over the past four quarters, is "significantly higher than we would like," and noted that "some indicators of longer-term inflation expectations have risen in recent months, which is a significant concern for the Federal Reserve." Today, gold is trading below its lowest levels of Tuesday, bond yields are higher, and implied yields on the fed funds futures curve are back near their highest levels of Tuesday.

Fact is, even if Bernanke intended for his words to be enough to shore up the dollar and forestall an actual policy response, the market would be unlikely to long give him that leeway. As easy as the Fed's stance remains at this point, without expectation of a policy shift coming fairly soon, the dollar's weakening trend would likely resume. And if Bernanke's gambit came to be seen as a hollow gesture, further damage to the Fed's credibility would result, and the currency could be launched on a sharp downdraft which would force a Fed response at some point.

Another factor likely nudging the Fed toward entering rate-hiking mode, even if it's sooner than they might prefer, is that the European Central Bank is giving clear hints that it is considering a near-term tightening. ECB officials came out of their policy session today transmitting an unmistakable message that they have serious concerns about the inflation outlook. Bundesbank president Axel Weber said markets should prepare for a policy response. That's why, in contrast with the other inflation-sensitive indicators today, the euro is rallying against the dollar, trading above $1.55. If Bernanke's concerns were primarily motivated by the dollar's weakening against the euro, as seems likely, he probably would not sit idly by for another episode of strengthening in the European currency. Indeed, it's not implausible to think that some degree of policy coordination between the Fed and ECB could be underway.

We're not losing sight of the fact that while Bernanke had made a clear shift toward hawkishness, at least rhetorically, there remain reasons to question the Fed's readiness to begin reversing the 325 bp in rate cuts effected since last September. For one thing, officials remain cautious about the economic outlook, continuing to emphasize the housing downturn as a negative factor. They also have ongoing concerns about financial market stability, and would be reluctant to take action that they believe could risk reigniting the intense turmoil seen in March.

But concern about the economy seems likely to become less of a factor moving forward. As it is, the bulk of macroeconomic indicators are now consistently surprising on the upside, and we think that's likely to continue. The mounting evidence is that the economy is now emerging from its two-quarter slowdown, and the current quarter could well see a growth rate of 2% or more. As for market conditions, at some level officials must understand that the greatest risk would come from allowing inflationary influences to become deeply entrenched, inevitably forcing the Fed to undertake highly aggressive tightening action in response. Avoiding the risk of significant damage to markets and the economy points to the advisability of beginning a gradual restoration of monetary equilibrium sooner rather than later.

BOTTOM LINE: Bernanke's comments this week amounted to a long-overdue acknowledgement of reality, which we see as a clear signal that the Fed is actively contemplating beginning to take back the rate cuts put in place since last September. While that's good news, how quickly they move, and how forcefully they're prepared to act once they do, will determine the inflationary price that will ultimately be paid for this period of monetary excess. We see a growing chance that the process could begin as soon as August, with potentially 75 bps in hikes coming before the end of the year. That won't be enough to restore equilibrium, but it would be a start.