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FED SHADOW

Splitsville

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In a showdown between the dovish Fed governors and the hawkish regional presidents, the governors win.

Since the close of trading Monday, the price of gold has fallen by about $45, the dollar has strengthened against the euro from below $1.59 to above $1.57, the yield at the short end of the Treasury curve has jumped from 2.60% to about 2.70%, and the fed funds futures curve has upped the odds on prospects for at least one rate hike in the fourth quarter. These signals -- that the policy outlook has shifted, away from the certainty of two weeks ago that the Fed won't take any near-term action to begin normalizing its exceptionally easy policy posture -- are encouraging in their own right. But we are hesitant as yet to view the market shift as being grounded in a realistic prospect that initiation of the necessary anti-inflationary policy change will be undertaken in a more accelerated manner (see "Indecision and Inflation" July 22, 2008). Thus, these moves are probably vulnerable to reversal once it becomes apparent that the policy outlook hasn't much changed from the status quo perception that has prevailed for several weeks.

Update to strategic view
FED FUNDS: A little weak data this morning, and the hopes from earlier in the week that the Fed might soon start moving rates back up to normal levels are dashed. Despite hawkish talk from courageous regional presidents, we fear the Fed board is likely to keep rates dangerously low until forced to move by palpable economic improvement or worsening evidence of an inflation outbreak.
[see Investment Strategy Dashboard]

The event explaining the action in these market indicators was a speech by Philadelphia Fed president Charles Plosser on Tuesday. In a highly astute assessment of the current inflation and policy environment, Plosser asserted that the Fed needs to "reverse course," and "sooner rather than later." Mindful of the experience of the 1970s, Plosser stated, "In recent months I have heard some analysts suggest that the current economic situation is not like the 1970s because unions are less prevalent and there is no evidence as yet of a wage-price spiral. Thus, a weak economy, with rising unemployment and declining payroll employment, will presumably prevent workers from demanding higher wages." But, he said, "that story has things backwards. It is not demands for higher wages that kick off the spiral, but the loss of confidence that the central bank will keep inflation controlled, which, in turn, leads to a rise in inflation expectations. The wage-price spiral is not the cause of the inflation, but the result." The lesson for policymakers, he said, is that if they "wait until they see the evidence of a wage-price spiral, they will be too late -- the public will have lost confidence in the Fed's ability to keep inflation under control, and this will make the job of bringing inflation down much more

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costly and difficult. Moreover, we could end up with a period of both low economic growth and high inflation."

Plosser warned against viewing the rise in energy and food prices as simply exogenous shifts in relative prices without implications for prospective inflation. "Policymakers must be careful in responding to relative price changes that tend to reduce economic activity while raising headline inflation," he said. "Monetary policy cannot control changes in the relative price of a key commodity, like oil or food. But it can help ensure that a relative price increase doesn't turn into a rise in overall inflation. Keep in mind that all sustained inflations begin with a change in relative prices. If policy becomes overly expansionary as it tries to address an economic slowdown, the relative price shock will result in higher inflation. That was the mistake we made in the 1970s."

Indeed, signs are growing that accommodation of the energy price spiral is showing through across the price spectrum. Non-energy CPI is up by 2.9% over the past year, and is rising by 3.4% on a three-month annualized basis. The Cleveland Fed publishes a trimmed-mean CPI in an effort to overcome the inherent flaws of simply arbitrarily excluding food and energy in the conventional core index. It is now up by 3.2% on a 12-month basis, the highest rate since 1992, when the indexes were decelerating from the inflation breakout of the late 1980s. This data casts considerable doubt on the notion that the recent pullback in crude oil prices will have a significant moderating impact on the near-term inflation outlook.

Plosser is not alone in his more hawkish policy perspective. Among other regional reserve bank presidents with voting power this year, Dallas's Richard Fisher has cast dissents at all of the FOMC meetings this year, voting against rate cuts at each meeting through April, and calling for an increase in the funds rate last month because "the risk that inflation would fail to moderate as expected by the Committee had increased substantially over the intermeeting period." Last week, the Minneapolis Fed's Gary Stern stated that "we can't wait until we clearly observe the financial markets at normal, the economy growing robustly…before we reverse." Among FOMC non-voters, Thomas Hoenig of Kansas City and Richmond's Jeff Lacker have made hawkish statements in recent weeks. In addition, the Fed this week released the minutes of its Board of Governors meeting prior to the June 25 FOMC meeting, at which the Dallas and Kansas City banks proposed a hike in the discount rate. The minutes say that the bank directors proposing the higher rate acknowledged downside risks to the economy "but concluded that they were outweighed by the upside risk of inflation." Interestingly, the minutes also cite "other directors" who noted that the Fed's liquidity facilities had relieved the strains in financial markets, and "under these circumstances they favored reversing some of the monetary policy easing that had been implemented in recent months." Presumably, these "other directors" were not concerned enough to ask for a hike in the discount rate (changes in the discount rate are considered by the board at the request of the reserve banks), but apparently they have common views with some of the more hawkish members who have recently gone on record advocating a policy shift.

It's important to bear in mind, however, that all of these rumblings are coming from the regional banks, who occupy what can be considered second-class status within the institutional framework of the Federal Reserve bureaucracy. Of the 12 reserve bank districts, only five have FOMC voting rights, on an annual rotating basis. If they all voted *en bloc* in opposition to members representing the board, they'd still be outvoted, 7-5. There has not yet been a single board member making similarly hawkish sounding statements. We first noted in January the differing perspectives surfacing between the board and the regions (see "Soft Spot, Not Armageddon" January 17, 2008). Going forward, it would probably behoove Fed chair Ben Bernanke and his board colleagues to find some way to mollify the regional bank presidents so as to avoid a public schism. At some point, these considerations could marginally incline board members toward beginning hiking rates earlier than they might otherwise prefer. At this point, however, there's not a hint to suggest that such considerations are in play. Thus, it appears that the speculation this week about the Fed being closer to entering rate hiking mode is unlikely to be borne out. In fact, the tenuous nature of this speculative turn could clearly be seen in today's fixed income trading, as part of the past few days moves were reversed in response to another dim new home sale report, and a small bulge in jobless claims. We have to wonder whether the drop in stocks today was driven by these economic reports, or by the prospect that the Fed is likely to keep fiddling while inflation continues to burn.

BOTTOM LINE: The robust response this week of market price indicators to hints that the Fed could be considering an early entry into rate hiking mode was impressive. It suggests that players in these markets want to believe the best about the Fed's intentions, and are still prepared to give policymakers the benefit of the doubt. Unfortunately, though, and much as we'd like to think otherwise, the speculation this week does not appear to be supported by a fundamental shift in the policy outlook. The Fed at this point still seems unlikely to take forceful enough action quickly enough to normalize policy and keep the inflation impulses embedded in the system from continuing to feed through.