Trend Macrolytics, LLC
Donald Luskin, Chief Investment Officer
David Gitlitz, Chief Economist
Thomas Demas, Managing Director

FED SHADOW

Fed Says, Give Us Some Slack

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David Gitlitz

Bernanke thinks the economy has turned the corner -- all the worse for inflation risk.

For all the talk about Fed chief Ben Bernanke offering a more upbeat view on the economy's prospects in his congressional testimony yesterday, he said nothing to alter our view that policy is likely to remain far too easy for far too long, bringing about a period of steadily rising inflation.

"We continue to expect economic activity to bottom out, then to turn up later this year," Bernanke told the Joint Economic Committee, citing signs of stabilization in the housing market and a slowing in the sharp pace of inventory liquidation that has been at work the past few quarters. But, he added, "Even after a recovery gets under way, the rate of growth of real economic activity is likely to remain below its longer-run potential for a while, implying that the current slack in resource utilization will increase further."

Update to strategic view
US MACRO: Bernanke's posture of cautious optimism about the economic outlook yesterday didn't give us any reason to think that the Fed might move toward a policy shift soon enough to forestall a significant inflation episode as the consequence of its massive anti-deflationary interventions of the last three quarters.
[see Investment Strategy Dashboard]

For this Fed, such "slack" is associated with generating downward price pressures. Thus, "in this environment," Bernanke said, "we anticipate that inflation will remain low. Indeed, given the sizable margin of slack in resource utilization…inflation is likely to move down some over the next year." That's consistent with the assertion in last week's FOMC statement that there is "some risk that inflation could persist for a time below rates that best foster economic growth in a context of price stability." In other words, the Fed sees the primary risk to price stability at this point on the side of deflation, not inflation (see "The Fed, Blinded by the Obvious" April 30, 2009).

Bernanke was asked yesterday how the Fed will know when it's time to start unwinding the massive liquidity add that it has built up since last September. He said the Fed would withdraw it in an "appropriate way" so as not to "snuff out" any recovery. So, the central bank must be counting on being able to take a leisurely approach to drawing down the liquidity, on the assumption that inflation will not be forcing its hand. Bernanke was asked by Representative Ron Paul (R-TX), the former Republican presidential candidate and long-time advocate of libertarian monetary principles, how the Fed would respond if inflation was running at 10% while

http://www.trendmacro.com
don@trendmacro.com
dgitlitz@trendmacro.com
tdemas@trendmacro.com

Offices:
Menlo Park CA
Parsippany NJ
Charlotte NC

Phone:
650 429 2112
973 335 5079
704 552 3625

the economy remained stagnant. After first insisting the premise of the question presented an unlikely scenario, he said the Fed would act to restore price stability. At some point, he said, the Fed would have to "take away the punch bowl."

Inflation is currently running at significantly less than 10%, but already it is presenting a significant challenge to the Fed's supposition that "resource slack" translates into reduced inflation pressure, or even deflation. After falling at a three-month annualized rate of nearly 8% in the deflationary velocity collapse of the fourth quarter, the personal consumption expenditure price index rose at a 2.2% three-month rate in the first quarter. Core PCE was up at a 2.3% rate. As far as we are aware, there has been no acknowledgement of this shift by anyone at the Fed. This is consistent with the story told by the market indicators we monitor, such as gold -- which is now trading back above $900 after plunging below $700 in the panic last fall -- that the intense deflationary forces were a consequence of the surge in money demand arising from acute risk abhorrence. Now, that risk abhorrence has been showing signs of significant relief, money demand is normalizing, and inflationary influences are beginning to surface again. And with the Fed in such an extraordinarily easy posture, those influences are likely to continue to be manifest for the foreseeable future.

Protesting too much
Six speeches in three weeks insisting the Fed's enormous balance sheet won't cause an outbreak of inflation

April 20, 2009
"The Economic Outlook"
FRB Vice Chairman Donald L. Kohn

April 18, 2009
"The Federal Reserve's Liquidity Facilities"
NY Fed President William C. Dudley
"Monetary Policy in the Financial Crisis"
Donald L. Kohn

April 14, 2009
"Four Questions about the Financial Crisis"
FRB Chairman Ben S. Bernanke

April 3, 2009
"The Federal Reserve's Balance Sheet"
Ben S. Bernanke
"Policies to Bring Us Out of the Financial Crisis and Recession"
Donald L. Kohn

For now, price pressures are still restrained enough for the Fed to continue to shrug them off. But at some point in the not too distant future, the Fed could be faced with a real dilemma. What do policymakers do if inflation begins to get into uncomfortable territory -- say rising at a rate above 3.5% -- but the Fed deems it is still too soon to expose the credit markets to an unwinding of its liquidity facilities and asset purchase programs? Would the Fed risk having to withstand another episode of credit market trauma? Would it have the political will -- especially it the moment of truth comes under the chairmancy of Larry Summers? Surely not. It is our baseline scenario that the Fed will be forced to accept a sustained rise in the price level.

BOTTOM LINE: Bernanke's posture of cautious optimism about the economic outlook yesterday didn't give us any reason to think that the Fed might move toward a policy shift soon enough to forestall a significant inflation episode as the consequence of its massive anti-deflationary interventions of the last three quarters. Continued "slack" will have the Fed maintaining its exceedingly easy posture even after recovery begins. The price of inflation-sensitive gold first fell on Bernanke testimony yesterday, but today is recovering much of its lost ground.