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

FED SHADOW

Steady -- And Easy -- As She Goes

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David Gitlitz

The Fed's abandonment of its deflation worries changes almost nothing.

Update to strategic view

US MACRO, FED FUNDS: The Fed yesterday acknowledged that the deflation threat has passed, but it did nothing to indicate that it is moving toward a less easy posture in light of growing inflation risk. The on-hold statement suggests the central bank is quite content to maintain its current stance indefinitely, which will only more deeply embed the inflation impulses that have begun spreading through the economy the last several months.

[see Investment Strategy Dashboard]

By removing the language that had appeared in its past three FOMC statements warning that it "sees some risk that inflation could persist for a time below rates that best foster economic growth and price stability in the longer term," the Fed yesterday signaled that it has called off its deflation alert. We had expected a move in this direction, but the outright elimination of any reference to deflation was a surprise (see "Too Soon to Stray" June 23, 2009). In the Fed's risk management framework, this implies that the objective of obviating any possibility of deflation will no longer be used to rationalize courting a significantly greater risk of inflation. It's potentially a significant shift, at least moderating the probability of a worst-case inflation outcome.

But this shift toward a marginally more hawkish tone doesn't alter the fact that the policy situation has not really changed in any meaningful way. In its statement yesterday, the Fed gave no hint that it is considering discontinuing or reversing its massive liquidity additions in the foreseeable future. And it continues to relegate inflation risk to a distinctly back-burner position under the fallacious "output gap" rubric that "substantial resource slack is likely to dampen cost pressures," so that "inflation will remain subdued for some time" (see "Fed Says, Give Us Some Slack" May 6, 2009). While acknowledging that "the pace of economic contraction is slowing," the weak economy is "likely to warrant exceptionally low levels of the federal funds rate for an extended period."

So while the fat tail risk of an inflation blowout may have been taken off the table with a lessening of concern with deflation-fighting, in practical terms it's not likely to make much difference. The dominant strand of thought among policymakers remains that, as Fed chair Ben Bernanke put it in congressional testimony earlier this month, "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." The persistence of this "slack" gives the Fed all it needs to justify maintaining its highly accommodative stance. While the economic

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

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and financial emergency conditions that the Fed, quite correctly, overcame with its bounteous liquidity injections late last year may have passed, the Fed remains committed to maintaining this posture as necessary to restore growth.

At this point, we can conceive of two potential scenarios that would have the Fed begin moving toward a neutral posture sooner rather than later. First, the Fed now asserts that "economic conditions warrant" maintaining an exceptionally easy policy stance. If conditions improve more rapidly than it now forecasts, presumably policy would also begin shifting more quickly. Second, if reported inflation starts ratcheting higher, at some point the Fed would have to acknowledge the reality, necessitating a policy response. Of the two, we'd rate the inflation scenario as more likely. As it is, inflation has shifted higher from its lows late last year. Core Consumer Price Index inflation is now running at a three-month annual rate of 2.3%, up from just 0.2% last December. That, however, is still probably at least 100 bp below the level that would get the Fed's attention.

In the bond market yesterday, long-term Treasuries responded to the Fed's announcement with yields popping higher by nearly 10 bp, the 10-year note yielding 3.69%. Ostensibly, this was attributed to disappointment that the statement did not contain language about the Fed expanding its Treasury purchase program. However, we think bonds could well have been responding to the steady-as-she-goes character of the statement, increasing the inflation premium as the Fed shows no inclination to even consider reversing its super-loose stance. At the short end of the curve, the yield on the 2-year note -- the issue most sensitive to policy expectations -- rose from 1.1% to a little more than 1.2%. But that is still more than 20 bp below the level seen following release of the better-than-expected May employment report earlier this month, which ratcheted up Fed tightening expectations (see "On the May Jobs Report" June 5, 2009). Today, the 2-year has rallied back to about 1.15%. Also, the implied funds rate one year out on the Fed funds futures curve is today at 0.95%, lower than its pre-FOMC level.

BOTTOM LINE: The Fed yesterday acknowledged that the deflation threat has passed, but it did nothing to indicate that it is moving toward a less easy posture in light of growing inflation risk. The on-hold statement suggests the central bank is quite content to maintain its current stance indefinitely, which will only more deeply embed the inflation impulses that have begun spreading through the economy the last several months.