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On Bernanke's Testimony

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Today's appearance on Capitol Hill by Fed chairman Ben Bernanke was less hawkish than we expected (see "Hawk Spotting" Monday, February 12, 2007). But we're hard pressed to find any hint of a suggestion in his testimony that the chances of a shift into a rate-cutting posture were enhanced. Nevertheless, interest rate futures upped their bet on the likelihood of a rate cut by year end by some 9 basis points, leaving December Eurodollar futures again fully priced for a 25 bp reduction by year end, and sparking a bond rally that pulled the 10-year Treasury back below 4.75% from yesterday's close above 4.8%. But the rally in gold, which traded above $670 during Bernanke's testimony, and the concomitant decline in the dollar, tell us that however overzealous the fixed income response might have been, indications that the Fed's current inflation-biased pause might remain in place indefinitely were sufficient to further intensify the looming inflation risks.

Update to strategic view

FED FUNDS: Bernanke's testimony was not as hawkish as we had expected and hoped. Thus our forecast for rate hikes as soon as the May FOMC meeting must be pushed back. But by staying the course as "data dependent," with the balance of risks pointing toward inflation, Bernanke said nothing whatsoever to justify the market's continued expectations for rate cuts. At most, the Fed is on hold as far as the eye can see. And even that is subject to disruption by data surprises on the upside, which we regard as entirely likely.

[see Investment Strategy Dashboard]

Bernanke's primary bow to the doves was his assertion that "inflation pressures have abated somewhat." However, this was immediately followed with the observation that "the core inflation rate remains somewhat elevated," noting that the "predominant policy concern is the risk that inflation will fail to ease as expected," and warning that the FOMC is "prepared to take action to address inflation risks if developments warrant." Although there are some signs that "inflation pressures are beginning to diminish," Bernanke said, "the monthly data are noisy…and it will consequently be some time before we can be confident that underlying inflation is moderating as anticipated." It should be noted that the "central tendency" of the FOMC's core personal consumption inflation forecast at 2 to 2.25% this year does not envision the rate dropping into the sub-2% territory many policymakers now insist must be attained. According to our models, moreover, core PCE inflation is considerably more likely to rebound from its current levels around 2.2% than to continue receding.

On growth, after noting that the FOMC's central tendency forecast put real GDP this year at 2.5% to 3%, Bernanke cautioned, "the risks to this outlook are significant." On the downside, while noting there have been signs that the housing downturn is stabilizing, the risk remains that the correction "may prove greater than we anticipated." He put considerably more emphasis, however, on the upside risk that "output may expand more quickly than anticipated if consumer

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spending continues to increase at the brisk pace seen in the second half of 2006." Reciting from the neo-Keynesian output gap playbook, the Fed chief warned that "upward pressure on inflation could materialize if final demand were to exceed the underlying productive capacity of the economy for a sustained period." Resource utilization rates are high, he said, as can be seen "most evidently in the tightness of the labor market." While the FOMC expects pressures in labor and product market to "ease modestly," the "possibility remains that tightness in product markets could allow firms to pass higher labor costs through to prices." The high rate of resource utilization "remains an important upside risk to continued progress on inflation."

BOTTOM LINE: All in all, Bernanke's testimony was entirely consistent with soundings from the Fed suggesting that while inflation remains the primary risk, for now they are content to patiently sit tight in their realm of data dependence and see what tomorrow brings. We had anticipated, based on recent musings of other Fed officials, that he might have been prepared to evince a more hawkish tilt, but apparently that would have been seen as jumping the gun, and is not yet in the cards. The longer the Fed waits to restore monetary equilibrium, the more it will need to do and the greater the risk that significant economic damage will ultimately be incurred. That was the message in today's moves in gold and foreign exchange. Our suggestion that the Fed might now be on track to resume the rate hiking exercise at the May meeting should probably be pushed back. But policymakers will at some point face the unavoidable reality that their task remains incomplete and a resumption of the process of restoring monetary equilibrium is inevitable.