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FED SHADOW

Inflation: Not the Worst Case, But Still a Case

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The Fed isn't going to be as easy as it once seemed, but it's still *very* easy.

The Fed has allayed worst-case inflation risks by taking steps to begin restoring its credibility while putting in place new mechanisms that finally appear to be staunching the credit market panic (see "Bernankruptcy" March 17, 2008). But it's important not to lose sight of the fact that monetary policy remains exceptionally easy, and it's unlikely to change soon enough to ultimately avoid serious inflationary consequences of the Fed's period of aggressive dovishness.

No question, the evident refocus on inflation coming out of last week's FOMC meeting was critical to establishing that price stability is still a Fed priority (see "Three Quarter Profile In Courage" March 19, 2008). In its all-consuming focus on subduing the market turmoil using aggressive cuts in the funds rate -- only belatedly inventing more targeted tools such as TAF, TSLF and PDCF -- the Fed apparently saw little risk in deemphasizing its inflation mandate as it pursued an apparently open-ended easing campaign. That was a serious miscalculation, as could be seen in the steep loss of dollar purchasing power against gold, oil, broader commodity indexes and forex, as well as the negative real yields that began to appear on CPI-indexed TIPS instruments (see "Well Anchored?" March 5, 2008). These indicators not only were pricing for the easy stance of current policy. They also reflected the widely held view, solidified by the statements of senior Fed officials themselves, that the central bank saw little to restrain it from remaining in easing mode indefinitely.

Update to strategic view

FED FUNDS: With a divided FOMC more frankly aware of inflation risks, and less dependent solely on the funds rate to quell credit market turbulence, we expect only a single 25 bp cut before the end of this easing cycle -- and perhaps not even that.
US MACRO: The introduction of new targeted liquidity tools to calm credit market turbulence has allowed the Fed to back away from the worst-case inflationary error that had been brewing just two weeks ago. But policy has been very easy for a long time, and is likely to remain so. There are still serious inflation impacts due to roll through the general price level, which the Fed will ultimately be compelled to address.

[see Investment Strategy Dashboard]

At last week's FOMC meeting, it appears that a faction of policymakers was no longer content to give that impression. Even after the committee defied expectations for the first time in this cycle by cutting the funds rate target by 75 rather than 100 basis points, two members -- Dallas Fed president Richard Fisher and Philadelphia's Charles Plosser -- dissented in favor of "less aggressive action." It would not be far-fetched to think that others among the 12 voting members

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were in their camp but refrained from dissenting in order to avoid giving the appearance of a serious breach within the panel. In any case, the nod to inflation reality, with the post-meeting statement noting that "Inflation has been elevated, and some indicators of inflation expectations have risen" -- the first explicit acknowledgment of rising inflation risk since prior to the outbreak of the market turmoil last August -- was very likely the product of vigorous advocacy by this more hawkish group. For the first time since this rate cut cycle began last September, the Fed signaled that it wants to conclude the easing campaign sooner rather than later.

But the rollback of inflation expectations following last week's FOMC meeting, with all of the above-noted indicators retreating smartly from their worst levels, also owes importantly to the Fed's creation of credit facilities to provide direct access to liquidity to institutions that have been under such heavy funding pressure in the credit crisis. In particular, the opening of the discount window to primary dealers appears to have gone a considerable distance toward relieving the counterparty risks that sank Bear Stearns, and were threatening to send a cascade of failures rippling through the financial system. In its first three days of operations last week, dealers tapped this new facility to the tune of nearly $29 billion. One clear sign of the salutary effect of this new source of liquidity has been the reversal of the safe haven play in short-term Treasuries. Three-month T-bill rates bottomed a week ago Monday at a yield just above 30 basis points. Today, the three-month bill is trading nearly 100 bps higher.

At the height of the panic a week ago Monday, futures markets were on their way to pricing for a funds rate of 1.25% by mid-year. Today, the futures are pricing for the Fed getting the rate to no lower than 1.75%. Provided the recent progress toward stability in the credit markets can be sustained, we'd expect to see these expectations recede further. Although another 25 bp cut to 2% late next month may be unavoidable at this point, it's not implausible to think that that could be the terminal point in this easing cycle, or -- barring renewed credit market turbulence -- that perhaps even we're already there. To be sure, either one would still leave policy in a highly accommodative stance. But it would still be considerably less so than seemed ceratin prior to last week's constructive developments.

The other aspect of this that should help keep a worst-case inflation scenario from playing out is that these signs of stability will also begin to feed into a more positive economic outlook. The weakness of current data primarily reflects the burden on risk-taking and capital formation imposed by the credit market panic. But this data is all backward-looking, telling us what *was,* not what *will be.* More sensitive, forward-looking gauges of risk tolerance are already showing significant improvement. The Merrill Lynch High Yield Index spread, for example, peaked on March 17 at 862 bps. It closed yesterday below 800 bps. It's conceivable that the current quarter will ultimately be recorded as growth-negative. But if recent trends are sustained and the market's capacity to bear risk continues to recover, that economic dip will prove to be short-lived. That should also keep the Fed from getting as accommodative as it would have if the weakness seemed likely to persist, as well as move forward the day when the string of easing moves can begin to be reversed.

None of this, however, removes the fact that the Fed's current posture is exceedingly easy and is likely to remain so for the foreseeable future. While the market price indicators of inflation expectations came off their most dire levels last week, they appear to be finding new ranges that are reversing part of the rollback. Gold, for example, today is trading close to $950, after getting below $920 late last week. That's better than the $1,000-plus level seen early last week, before the Fed's backed away from a worst-case inflationary error. And if the Fed stays backed away from it, we wouldn't expect that gold would regain or exceed last week's record highs (see "Inflation Inflection" March 25, 2008). But as easy as the Fed still is now, a trend that would indicate a sustainable rebuilding of dollar purchasing power is highly unlikely. At these levels, moreover, gold is trading at levels more than double its 10-year moving average of $414. That provides some indication of the serious inflationary influences embedded in the system that have yet to feed through the general price level.

BOTTOM LINE: The Fed's nod last week to inflation reality, together with its establishment of credit facilities to relieve short-term funding pressures, has put a sizeable dent in the worst-case inflation scenario. Although the Fed remains in a highly accommodative posture, the terminal point of this cycle is unlikely to be as easy as seemed likely before last week's developments. That still leaves policy in a position that ultimately will incur a substantial inflationary price for this episode of Fed policy activism, which inevitably will involve a period of policy activism at least as aggressive on the tightening side as this has been on the easing side.