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MACROCOSM

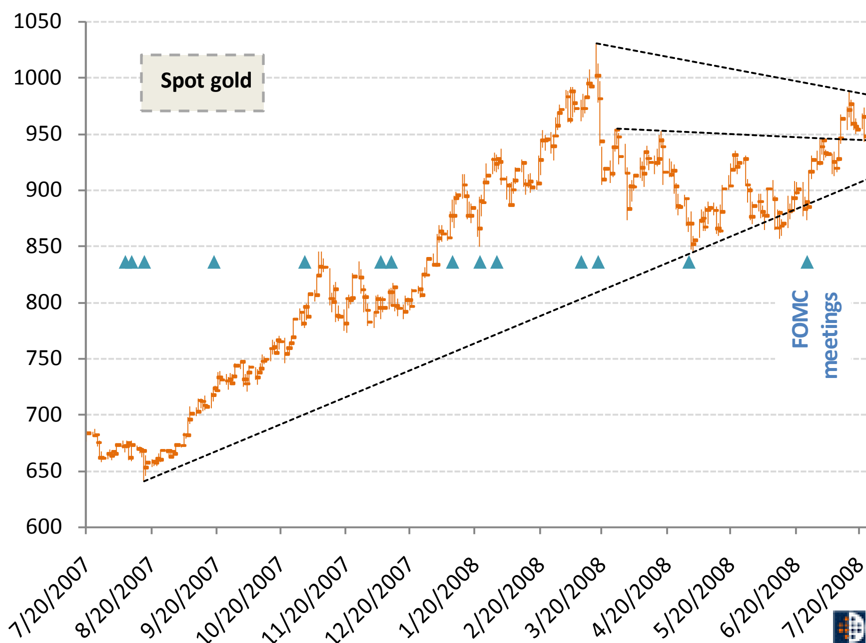
# Indecision and Inflation

Tuesday, July 22, 2008

**Donald Luskin**

**As stocks have recovered, so has a glimmer of hope that the Fed might get it right.**

Stocks have pulled back from the brink, as we expected they would (see "Will the GSE Rescue Work?" July 14, 2008). But has the Fed pulled back from the brink too, as we expected it would *not* (see "Stocks are Cheap, But the Fed's Asleep" July 15, 2008)? In the short-run these two questions are linked. It's no surprise that one week ago, at the worst of the collapse in financial stocks, there was a near abandonment of any expectations for Fed rate hikes this year -- and the inflation risks associated with that drove gold to new recovery highs, and very nearly sent the trade-weighted dollar to all-time lows. Now that things have pretty much stabilized in the financial sector -- even in the face of some new write-off and earnings shockers -- futures markets are once again expecting a single rate hike by year-end, and the inflation-sensitive




**Update to strategic view**

**US STOCKS:** We expect stocks to continue to stabilize and work higher from last week's panic lows.

**US RESOURCE STOCKS, GOLD, OIL, COMMODITIES, US DOLLAR:** As stocks have recovered somewhat -- especially in the financial sector -- the dire inflation risks implied last week have moderated. Our call remains that the Fed won't have the courage to normalize rates quickly enough to prevent another round of rising inflation expectations, but the sharp drop in some inflation-sensitive markets over the last week is making hope plausible.

[see Investment Strategy Dashboard]

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markets we track have all moderated considerably.

Markets aside, on Thursday we got a piece of economic news that could be something of a game-changer for the Fed. The day before, Ben Bernanke had testified before Congress that recent elevated inflation readings were, in essence, the result of an exogenous energy and commodity price shock. His proof was that *core* inflation -- which excludes food and energy -- "has been fairly steady this year." And the day before that, the minutes of the June 25 FOMC meeting had made much the same point in even stronger language, noting that "core inflation had improved somewhat." But Thursday's Consumer Price Index report for June threw all that in a cocked hat. Core CPI was reported at 0.33% for the month, for an annual rate of 3.9% -- the highest monthly reading in almost seven years. We know from private conversations with Fed officials that, in their heart of hearts, they are terrified of the possibility that a serious inflation outbreak is already irrevocably underway. Like atheists in a fox-hole, they are grasping at fictions such as their exogenous shock theory to comfort themselves. Thursday's core CPI goes some way toward stripping away that particular fiction, forcing the Fed to more highly weight inflation risk as it considers the impact on the financial sector of expeditiously moving rates back toward more normal levels (see "Fannie and Freddie Fan Inflation Fire" July 11, 2008).

That said, last week's sharp drop in the crude oil price could be another game-changer for the Fed -- but it's difficult to tell in which direction it will operate. On the one hand, under the exogenous shock theory, a fall in the oil price is *ipso facto* a reason to expect *lower* headline inflation. Though under the theory it should make no difference to *core* inflation, a lower price for this most visible of consumer commodities should help keep inflation expectations "anchored" or "moored," to use the Fed's favorite expressions for this critical factor. On the other hand, a lower oil price removes a threat to growth. And under another of the Fed's favorite theories -- the Phillips curve -- higher growth is *ipso facto* a reason to expect *higher* inflation. It must be difficult for the Fed -- not just to deal with so much chaos and so many risks, but to be guided by a collection of theories that are not only erroneous but, at the moment, are pulling in opposite directions. In the presence of such contradictions, the typical institutional approach is -- sadly, in this case -- to do nothing at all.

*Nothing* would be a big problem. It doesn't take a *lower* funds rate -- such as was expected in mid-March at the worst of the Bear Stearns crisis -- for the Fed to fall over the brink into a new worst-case inflation scenario. It's not just a question of the level of rates, but also of time and of context. If the Fed keeps rates where they are now -- that is, well below the rate of inflation -- for long enough, the inflation impact may be just as bad as if the Fed had lowered rates more in March. And if the Fed doesn't raise rates quickly enough in the face economic growth higher than the doomsday expectations that seem to dominate the consensus, again the inflation impact can be severe.

Just a week after yet another near-death experience in credit markets -- this time with Fannie and Freddie rather than Bear Stearns -- we have little confidence that this very cautious Fed will act with sufficient speed. But it's not a sure thing in our minds, so in an important sense we are second-guessing our call last week for going back on full-on inflation alert (again, see "Stocks are Cheap, But the Fed's Asleep"). To us, the need to address inflation pressures is so urgent, the unappreciated strength of the economy so manifest, and the collection of new non-monetary tools in the Fed's armamentarium so powerful, we can scarcely make ourselves believe the Fed would be so timid and foolish as to *not* raise rates, and deal with the mounting inflation threat while it can still do so fairly easily. Yet we fear that the Fed may have "missed the window" to do the right thing. It would have been easier two months ago, before the Fannie and Freddie crisis erupted, when Bernanke was testing the waters by talking in a speech about the Fed's important role in supporting the foreign exchange value of the dollar (see "The Bernanke

Awakening" June 5, 2008). Is hope still justified? We like to think so, yet it seems that the one way in which this Fed never disappoints is that it never fails to disappoint.

The gold chart on the previous page says it all. Its ambivalence -- is it in an uptrend or a downtrend? -- says we can't know with high confidence whether the Fed will manage to pull back from the brink of a new worst-case inflation scenario, or whether events (or, more precisely, the Fed's perception of events) will drag it over the brink. As of this writing, with stocks showing great resiliency in the face of American Express's earnings warning that seemed to have dire implications for the consumer economy, the gold price has fallen sharply -- right back to the mid-level of the indecision pattern etched out in the chart. It could go either way. For the moment, we're still betting that the Fed will get this one wrong.

**BOTTOM LINE:** We expect stocks to continue to stabilize and work higher from last week's panic lows. As stocks have recovered somewhat -- especially in the financial sector -- the dire inflation risks implied last week have moderated. Our call remains that the Fed won't have the courage to normalize rates quickly enough to prevent another round of rising inflation expectations, but the sharp drop in some inflation-sensitive markets over the last week is making hope plausible.