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

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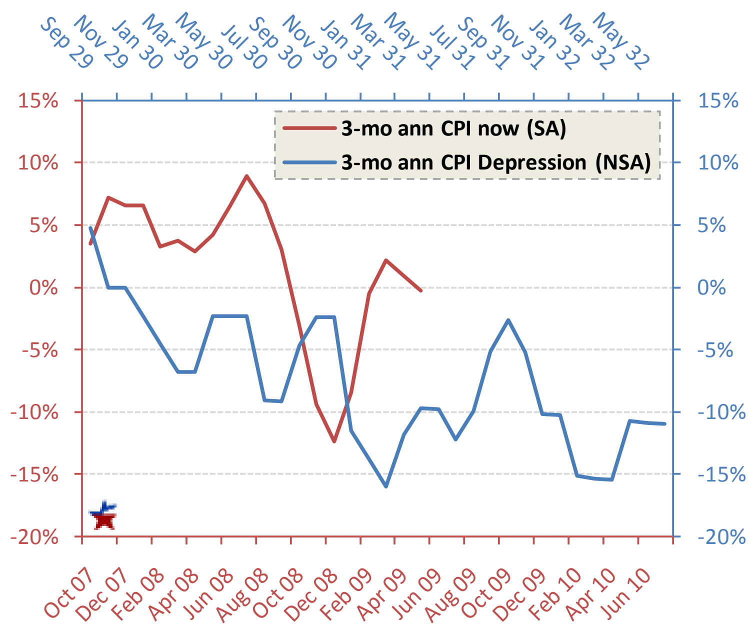
Can Inflation Plays Do Without Deflation?

Thursday, June 25, 2009
Donald Luskin

Yesterday's FOMC takes some of the edge off, but the inflation theme is alive and well.

Update to strategic view
GOLD, OIL, COMMODITIES, US RESOURCE STOCKS: The FOMC's abandonment of any explicit concern about deflation reduces the upside somewhat for the "inflation plays," as the Fed will apparently now be less prone to a policy overshoot on the side of inflation. But we still think that the Fed will inflate more than the consensus expects, lulled by its output gap analytical framework, stuck with a massive balance sheet, and under irresistible political pressure to produce economic recovery.
[see Investment Strategy Dashboard]

As noted earlier today, we were surprised by yesterday's FOMC statement's outright elimination of prior statements' references to the risk of deflation (see "Steady -- And Easy -- As She Goes" June 25, 2009). While we don't see this signaling a sea change in the Fed's policy posture, it can't help but somewhat dim our enthusiasm for "inflation plays" such as gold, commodities, energy and resource stocks. If the Fed is less worried about *deflation*, it will be less prone -- in the context of its risk management model that we discussed earlier this week (see "Too Soon to Stray" June 23, 2009) -- to a deliberate policy overshoot on the side of *inflation*. And at the same time, by doing less to pre-empt deflation, the Fed increases at the margin the probability that deflation will in fact recur. Combined, the lower probability of an inflationary overshoot and the higher probability of deflation reduce the potential upside for the inflation theme.



We first sounded a note of caution on the inflation theme three weeks ago, when Ben Bernanke said more than once in congressional testimony that the risk of deflation had "receded somewhat" (see "They Laughed When I Sat Down to Monetize" June 4, 2009). And yesterday's apparent abandonment of any concern about deflation at all makes us even more

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

Offices:
Menlo Park CA
Parsippany NJ
Charlotte NC

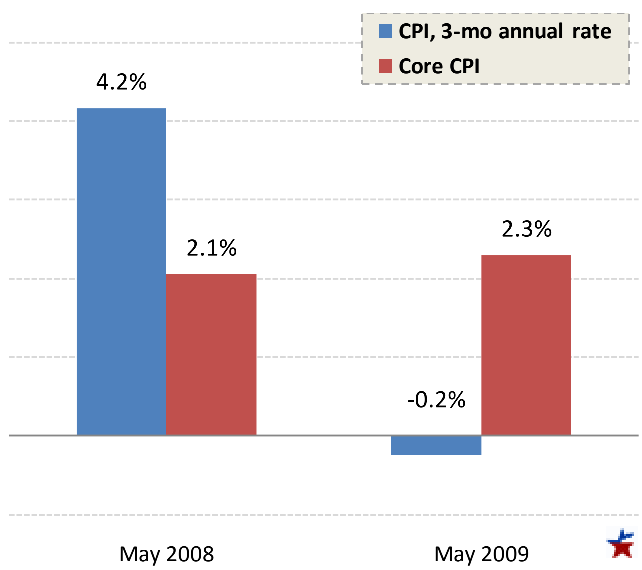
Phone:
650 429 2112
973 335 5079
704 552 3625

cautious. But at this time we are not abandoning the theme -- only moderating the extreme level of our enthusiasm for it. Speaking strictly symbolically, if our previous price target for gold had been $1500, it's now $1300. The inflation theme is not dead, because the probability of serious inflation is still quite high -- and we believe it is underestimated in the consensus.

First, we think it's highly unlikely that the Fed has actually stopped worrying about deflation altogether, the failure to mention it yesterday notwithstanding. How could it possibly *not* worry about deflation? As the chart on the previous page shows, as recently as last December the Consumer Price Index was registering deflation at a three-month annual rate of 12.4%, approaching the catastrophic levels experienced at the worst of the Great Depression of the 1930s. To be sure, the CPI has recovered from that terrible brink, thanks to the decisive actions of the Fed to vastly expand the supply of monetary liquidity in the face of an unprecedented surge in demand -- deflation is now running at a three-month annual rate of only 0.2%. Deflation is, in fact, very likely over. But so soon after the near-death deflationary experience of last winter, no prudent central banker would allow himself to declare "mission accomplished." So while the Fed may not aim for the same extreme level of inflationary policy overshoot that its risk management model would call for with a higher weighting for deflation risk, we still expect some considerable degree of such overshoot out of respect for any deflation risk that may still linger, however small.

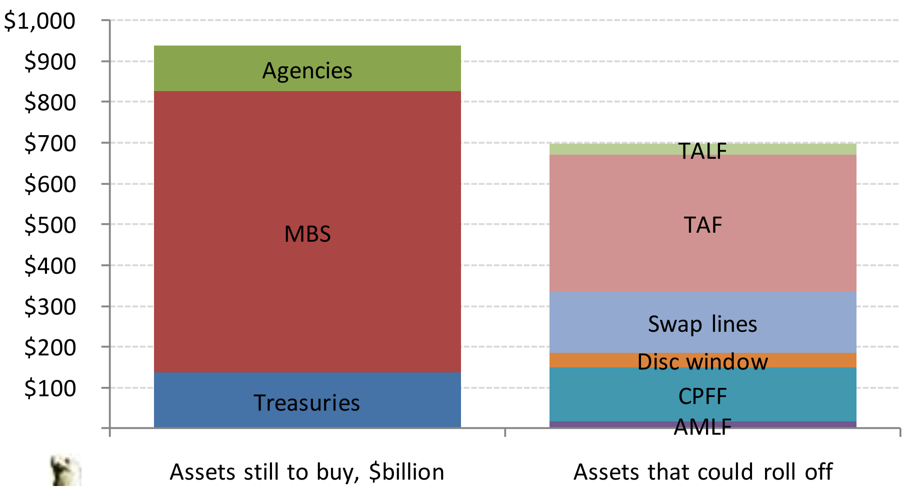
Second, even with no deflation fears at all, the Fed is still likely to err on the side of inflation because of its devotion to its fallacious "output gap" model, which holds erroneously that inflation is impossible in a economy with a high unemployment rate or other symptoms of economic slack (see "Fed Says, Give Us Some Slack" May 6, 2009). This model is, in some sense, an article of religious faith at the Fed -- so it blinds policy-makers to what ought to be self-evident realities. For example, yesterday's FOMC statement said,

> The prices of energy and other commodities have risen of late. However, substantial resource slack is likely to dampen cost pressures…



This sounds very much like statements the Fed was making about a year ago when it needed an explanation for why CPI inflation was rising alarmingly, even as the economy was beginning to fall into recession -- something that can't happen under the output gap model. So the Fed focused on core inflation then, which was not rising as alarmingly, because it stripped out soaring food and energy prices. But it's nonsensical to use this same alibi for the failed output gap model *now* -- because taking out food and energy makes inflation look *worse* now, not better. On a three-month annual basis, core CPI is running at 2.3% *inflation*, while the overall CPI is running at 0.2% *deflation*. The output gap is likely to beguile the Fed for quite a while. That's because we feel confident that the recession is in the process of bottoming, but we fear recovery will be lackluster -- so a lot of economic slack, especially in the labor market, is likely to remain (see "The Case for Ambivalence" June 12, 2009). Ironically, thanks to the Fed's faith-based model of inflation, the very slack that the Fed believes prevents inflation is the very thing that will cause inflation -- because of the way the Fed will likely react to it.

Third, and related, the prospect of a lackluster recovery is an uncertain and optimistic scenario. For us it's the base case, as it seems to be for the Fed -- but it must be acknowledged that what has happened to the global economy over the last year is unique, and leaves a world that is more than usually unpredictable (again, see "The Case for Ambivalence"). Though the Fed saw fit not to mention the risk, it's not hard to imagine things that could go terribly wrong and throw the world back into deflation. In fact, as we mentioned at the outset, the fact that the Fed is now in a lower state of alert on deflation marginally raises the chances that deflation will recur. But if that were to happen we have no doubt that the Fed would swiftly react -- and having erred by giving an implicit "all clear" yesterday, would likely *over*-react. Even a turn for the worse that was simply *contractionary* -- rather than an overtly *deflationary* panic like that of late last year -- would likely reset the Fed's risk management model for maximum inflationary error, in response. So it's possible that while the Fed's seeming abandonment of its concern about deflation raises the risk of *deflation in the near term*, the likelihood that the Fed would react all the more intensely to the eventuation of that risk raises the probability of *inflation in the long term*.



Fourth, the Fed will likely find it difficult to actually do anything to tighten policy anytime soon, even if everything goes right. Yesterday's statement did nothing to suggest that planned asset purchases of another $940 billion -- in Treasuries, mortgage-backed securities, and agency obligations -- are likely to be scaled back. But of the emergency liquidity programs on the asset side of the Fed's balance sheet, *at most* only $697 billion can be expected to roll off anytime soon (in fact, the Fed announced this morning that they are all being extended). That means a net asset expansion of $243 billion. At the same time, it seems to us that the Fed is at risk of losing its financing. Presently the liability side of its balance sheet is dominated by $685 billion in excess reserves put on deposit by banks. As the economy recovers and banks begin lending again, those deposits will evaporate. Technically, the Fed could hold on to those deposits by raising the interest rate it pays on them -- but if the Fed's goal is the resuscitation of the banking system's lending capacity, this is exactly what it would *not* want to do. And we doubt the cash-strapped US Treasury will want to increase the $333 billion it has on deposit with the Fed (see "Treasury Won't Bail Out the Fed" February 17, 2009). Whether it's adding to the asset side, or losing from the liability side -- either way, these are dollars the Fed will simply have to print.

Fifth, we can't rule out politics. The Fed is nominally a politically independent agency, but the reality is that its chairman is a political appointee, and Ben Bernanke's term as chairman is almost up. We understand from sources close to him that he wants to be reappointed, especially as he has reportedly been lobbying for expanded powers for the Fed as "systemic risk regulator." With the economy still struggling to come out of recession, with the

unemployment rate at 9.4% and with the federal government's borrowing needs growing, it strains credulity to think that Bernanke would dare to be anything but extremely accommodative -- especially when his output gap model gives him a plausible excuse to ignore the inflationary consequences of doing that which is politically necessary. If Bernanke doesn't play ball, it's not hard to think that inflation risk would be even worse under the chairmancy of Larry Summers.

Finally, we note that the price of gold -- the purest of the "inflation plays" -- has barely budged since yesterday's statement, as of this writing. Other less pure plays, such as energy and resource stocks, are very strong today. So it would appear that yesterday's statement was not news, that the pullback by the inflation-sensitive sector from its highs earlier this month was a gradual discounting of the Fed's pulling back from high-alert on deflation (again, see "They Laughed When I Sat Down to Monetize"), or for that matter perhaps only a sympathetic reaction to the general correction in risky assets that has been underway. That the adjustment has been so small, and that there would be no further reaction after yesterday's statement, are hints that while the upside may now be less than previously expected, the inflation theme is hardly dead.

BOTTOM LINE: The FOMC's abandonment of any explicit concern about deflation reduces the upside somewhat for the "inflation plays," as the Fed will apparently now be less prone to a policy overshoot on the side of inflation. But we still think that the Fed will inflate more than the consensus expects, lulled by its output gap analytical framework, stuck with a massive balance sheet, and under irresistible political pressure to produce economic recovery.