Trend Macro

FED SHADOW

# Sucker Trade: Inflation for Jobs

Thursday, December 17, 2009

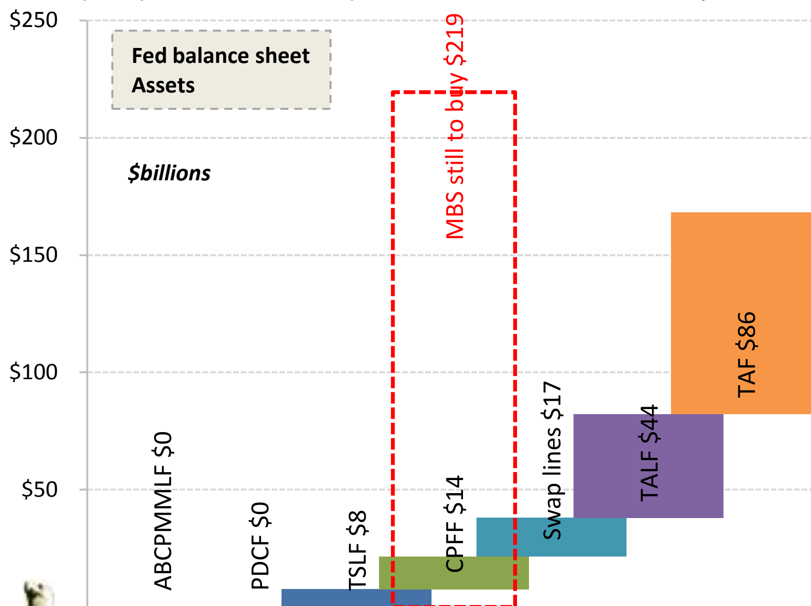
**Donald Luskin**

**Citing the lessons of the 1970s, the Fed seems ready to repeat its mistakes of the 1970s.**

| Update to strategic view |
|---|
| **FED FUNDS, US MACRO:** The FOMC sees marginal improvement in growth prospects, and no inflation risk, so it continues to promise of an "extended period" of low rates. The apparently extensive decommissioning of liquidity programs will have negligible effect on the balance sheet. Separately, Bernanke indicated that he believes short-term inflation can improve employment. We continue to expect inflation pressures to build. |
| [see Investment Strategy Dashboard] |

Yesterday's FOMC statement was a non-event. But another statement this week from Ben Bernanke raises our already high concerns about inflation risk.

As Bernanke virtually promised in a public statement last week, the FOMC reiterated the commitment to "exceptionally low levels of the federal funds rate for an extended period" (see "No Game-Changer" December 8, 2009). Other language in the statement pointed to perceived small incremental improvement in growth prospects. For example, last month's loss of only 11,000 payroll jobs led the FOMC to state that "deterioration in the labor market is abating." That said, the Fed appears to share our concern that the issue is not arresting jobs losses, but rather reversing the economy's incapacity to create new jobs, noting that "Businesses… remain reluctant to add to payrolls" (see "On the November Jobs Report" December 4, 2009). The Fed is also focused on another issue we have highlighted: that though consumption has started to grow, "Businesses are still cutting back on fixed investment" (see "The Case for Ambivalence, Volume Two" December 14, 2009).




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

Copyright 2009 Trend Macrolytics LLC. All rights reserved. This document is not to be forwarded to individuals or organizations not authorized by Trend Macrolytics LLC to receive it. For information purposes only; not to be deemed to be recommendations for buying or selling specific securities or to constitute personalized investment advice. Derived from sources deemed to be reliable, but no warranty is made as to accuracy.

The FOMC also announced that several of its liquidity programs will likely be allowed to expire at various points in the first half of next year -- the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility, the Commercial Paper Funding Facility, the Primary Dealer Credit Facility, the Term Securities Lending Facility, the Term Asset-Backed Securities Loan Facility, and the Fed's swap lines to other central banks. Also, the Term Auction Facility will continue to be scaled back. There is much less to this seeming balance sheet reduction than meets the eye. Two of these programs already contain zero assets. And if all of rest were to drop to zero (which TAF likely will not, and TALF simply cannot for years due to the longevity of its existing commitments), the asset side of the Fed's balance sheet would shrink by $168 billion. Since the Fed is committed to buy another $219 billion in mortgage-backed securities, we can expect it to hold at least $51 billion more in assets by the middle of next year than it has today (see the chart on the previous page).

The FOMC's inflation outlook remains word-for-word with that of the prior meeting: "With substantial resource slack likely to continue to dampen cost pressures and with longer-term inflation expectations stable, the Committee expects that inflation will remain subdued for some time." We believe that the Fed errs when it seems to utterly ignore the inflation alarms being sounded by the falling dollar, and by rising commodity prices -- especially the price of gold, which hit new all-time highs since the prior meeting. What's more alarming, Bernanke gave us reason to wonder whether he would act even if he didn't ignore them. He wrote this week in a letter to Senator Jim Bunning (R-KY) [emphasis added]:

> If declines in the dollar and increases in commodity prices were creating upward pressures on consumer prices and causing expectations of future inflation to rise, those developments would be taken extremely seriously by the Committee, and **would have to be balanced against the high rate of unemployment…** But **the clear lesson from the experience of the 1970s…is the high cost that a nation pays in terms of macroeconomic performance** when it loses sight of the importance of maintaining a credible plan for the achievement of price stability *and* maximum sustainable employment **in the medium and longer terms**.

We interpret this to mean that Bernanke believes that inflation is price a nation can choose to pay to obtain higher employment -- and that it is likely a reasonably price, provided there is a plan to contain that inflation to the short-term. We think this belief is dangerously mistaken in every respect. We believe that inflation expectations are already rising, and that the dollar and gold are *prima facie* evidence of it. We don't believe that inflation can create jobs. And we don't believe the Fed is sufficiently skilled or credible to contain inflation, once unleashed, to only the short term. To us, *that* is the "clear lesson from the experience of the 1970s."

**Recommended reading**

**The predictive power of Google data: New evidence on US unemployment** Francesco D'Amuri Juri Marcucci, VoxEu, December 14, 2009

**The World Needs Further Monetary Ease, Not an Early Exit** Joseph E. Gagnon, Peterson Institute for International Economics, December 2009

[Recommended Reading home]

**BOTTOM LINE:** The FOMC sees marginal improvement in growth prospects, and no inflation risk, so it continues to promise of an "extended period" of low rates. The apparently extensive decommissioning of liquidity programs will have negligible effect on the balance sheet. Separately, Bernanke indicated that he believes short-term inflation can improve employment. We continue to expect inflation pressures to build.