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TRENDMACRO LIVE!

On the September FOMC

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It couldn't be clearer. For the Fed, reflation is not just a mission but a mandate.

As expected, no "QE2" in today's FOMC statement. But at first glance the aggressive posture taken today on reflation does seem surprising. We think Ben Bernanke and his intimates on the Board of Governors are not especially worried about the prospect of monetary deflation, seeing high commodity prices as putting a cost-push floor under consumer prices (see "Dialing Down the Drama at the Fed" September 16, 2010). Yet in today's statement, otherwise mostly unchanged from last month's, there is this substantially altered paragraph (new text red underlined, deleted old text ~~red struck through~~):

> *Measures of underlying inflation ~~have trended lower in recent quarters and~~ are currently at levels somewhat below those the Committee judges most consistent, over the longer run, with its mandate to promote maximum employment and price stability. With substantial resource slack continuing to restrain cost pressures and longer-term inflation expectations stable, inflation is likely to ~~be~~ remain subdued for some time~~.~~ before rising to levels the Committee considers consistent with its mandate.*

But this is not really so surprising. It does not express concern about deflation *per se*, but rather a concern about insufficient inflation. Indeed, it frames the need for a higher inflation rate as a part of the Fed's mandate.

We see this as shifting the balance of probabilities in favor of more quantitative easing. Bernanke in his Jackson Hole speech emphasized the importance of passing a cost-benefit test before more unusual policy steps could be taken -- which would appear to rule them out, if labor market weakness is the problem being addressed, because even a trillion dollars in bond purchases wouldn't create any new jobs. But if insufficient inflation is the problem, then the cost-benefit test is easily passed -- a trillion dollars in QE can most definitely create some reflation. At the very least, it underscores our long-standing expectation for a low funds rate "forever" (see recently "Fixed Income Strategy: Take The Low Road" June 16, 2010).

Last week we talked about the gathering evidence that deflation was not a serious risk, and indeed that reflation was just beginning to take hold.

Update to strategic view

FED FUNDS: No "QE2" -- but instead a full-throated commitment to reflation as part of the Fed's mandate. This sets the stage for quantitative easing in the future, because it overcomes the objection that such steps cannot create jobs -- but they can surely create reflation.

GOLD: Gold went from being down on the day to new all-time highs within minutes of today's FOMC statement. The explicit commitment to reflation as part of the Fed's mandate means that inflationary warning signals such as record gold prices will be more than ignored or tolerated -- they will be welcomed. We continued to look for gold to keep working to new highs.

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Today's FOMC was a clear sign that such evidence -- including the record gold price -- is welcomed by the Fed, not just ignored or tolerated, and certainly not feared. No wonder gold went from being down on the day to new all-time highs within minutes of today's statement.

Bottom line

No "QE2" -- but instead a full-throated commitment to reflation as part of the Fed's mandate. This sets the stage for quantitative easing in the future, because it overcomes the objection that such steps cannot create jobs -- but they can surely create reflation. Gold went from being down on the day to new all-time highs within minutes of today's FOMC statement. The explicit commitment to reflation as part of the Fed's mandate means that inflationary warning signals such as record gold prices will be more than ignored or tolerated -- they will be welcomed. We continued to look for gold to keep working to new highs.

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