

FED SHADOW

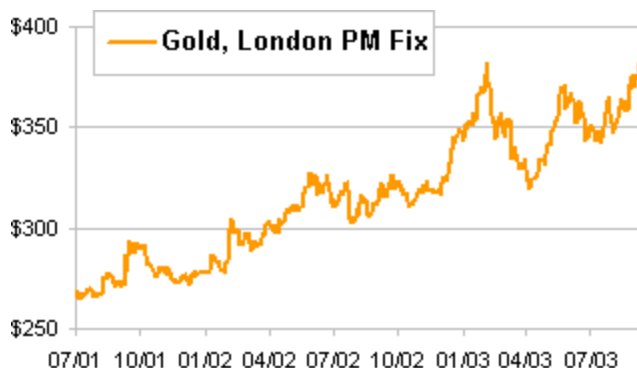
Gold at \$380

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The Fed's confused belief that its role is to regulate the labor market is again putting monetary risk in play.

Fed Chairman Alan Greenspan long ago abandoned his professed regard for price-rule signals as policy guideposts, but it's unlikely that he has entirely ignored the sight of the gold price breaching the \$380 plateau for the first time in seven years. For the most part, the steady recovery of gold from levels around \$270 since late 2001 has reflected an entirely salutary reflationary shift from what had been a relentlessly deflationary Fed policy stance. Circumstances surrounding this latest gold price pop, however, strongly suggest that the Fed is now at growing risk of inducing an inflation overshoot in endeavoring to correct its previous deflation error.



As much as he may have turned away from the classical monetary principles that once formed the core of his policy perspective, Greenspan knows that gold remains unique in its monetary properties, signaling shifts in the supply/demand balance for money more readily than any other indicator. But while Greenspan is likely cognizant of the risk indicated by gold rising from earlier ranges around \$350 to \$360, it's doubtful that that he would now be equipped to act on it even if he wanted to. The recent public comments of a succession of Fed officials

indicate that they remain enthralled by output-gap rationalizations positing that rising inflation is essentially impossible during a time of still-slack "resource utilization." This consensus will not easily be turned toward support for policy tightening until the central bankers are convinced such action is justified by new data -- particularly the lagging, backward-looking employment data. With such misguided notions are the seeds of monetary error planted.

It was the most pointed of those Fed officials' remarks given last week, by **Fed Governor Ben Bernanke**, that triggered this latest inflation-risk outbreak. For Bernanke, continued labor market stagnation in the face of rising output not only indefinitely puts off the date when a somewhat more restrictive stance would become appropriate. According to the former **Princeton** economics professor, such stagnation "may possibly require monetary ease, rather than monetary tightening, in the short run" (see ["August Jobs Report -- What It Doesn't Mean,"](#) September 5, 2003).

It would be difficult to overstate the fallaciousness of Bernanke's reasoning. Inflation and deflation are *monetary* phenomenon, caused by an excess (inflation) or dearth (deflation) of

dollars relative to demand. These evils are not produced by too much or too little job creation; they can only be occasioned by the Fed creating too much or too little liquidity, over which it has a supply monopoly. One would think that its experience coming out of the late 1990s might have taught the Fed a valuable lesson about the dangers of allowing real economic variables such as job creation to distract from its mission of stabilizing the unit of account. Believing that a tightening labor market was the manifestation of an economy on the verge of inflationary overheating, the Fed pursued a massively too-tight policy course, resulting in the dollar's deflation by upwards of 30% against gold, other sensitive commodities, and foreign exchange. The plunging profits, skyrocketing risk premiums, and collapse of the market's risk tolerance from 2000 to 2002 were all products of the Fed's misguided vigilance.

In Bernanke's comments, we see the clear potential for the Fed to commit the mirror image of this deflation error. Believing that a so-called "jobless recovery" represents a deflation risk, the Fed could stay too easy for too long, spurring an outbreak of sharply higher inflation. It's possible that the economy's emergence into a vigorous expansion phase will save the Fed from the worst consequences of its inflationary bias, as a robust demand for dollars absorbs at least part of what could otherwise be a developing liquidity surplus. Indeed, until the forex market got its fill of Fed speakers last week and plainly saw the currency implications, the dollar had rallied by nearly 8% since mid-summer against its major-currency counterparts. Since then, the G-6 trade-weighted dollar index has fallen in concert with the risk to dollar purchasing power indicated by the rising price of gold.

It could be, however, that the labor market is due for the long-awaited rebound that will mollify policymakers and set the stage for the needed change in policy direction before the current inflation risk becomes inflation reality. As we noted last Friday, while the **Department of Labor's** "establishment survey" continues to show a *contraction* in payrolls, the "household survey" has been showing healthy overall job *growth* for several months, and could be a leading indicator of higher payroll numbers in the offing. In addition, there were some intriguing signs even within the establishment survey suggesting that all is not quite as bleak as it might first appear. For one, the report of another contraction in non-farm payrolls was based on seasonally adjusted data. The unadjusted data, however, showed total private-sector payrolls growing by 10,000, with goods-producing jobs up by 78,000 and manufacturing by 45,000. While seasonal adjustment can be a useful tool for smoothing out "normal" month-to-month discontinuities in the data, it could be that the formula is not accurately picking up the current dynamics of the labor market in a non-normal environment.

There may also be some interesting parallels between the employment data being collected on the current jobless recovery and the previous one coming out of the 1990-1991 recession. It turns out that that recovery was not nearly as jobless as was believed at the time, and subsequent revisions to the data identified some 500,000 payroll positions that went unreported initially. The problem, it seems, is that hiring by small businesses is routinely underrepresented in the establishment survey. To overcome the problem, the **BLS** routinely plugs in an adjustment factor that the agency acknowledges often does not capture upturns in hiring. And coming out of a job market slump, small businesses are usually the first to begin hiring again.

Our bet is that at some point in the next few months, a turn in the jobs market will become apparent, and the expectations of forthcoming Fed rate hikes that were substantially marked down over the past several days will again come to the fore. After discounting for as much as 100 basis points in rate hikes by next June, the Eurodollar futures contract coming due that month is now priced for between 25 and 50 basis points in hikes. We are maintaining our still-profitable [model position short the Eurodollar contract](#), and are awaiting an opportunity to double up on the position when a sentiment shift is again at hand.

Longer-maturity issues, with the 10-year note at a yield below 4.3% having rallied by more than 30 bps in the past week, could well get caught between a rock and a hard place. If, as we think likely, Fed rate hikes again are put in play in the next several months, the longer end of the curve won't be immune to renewed price reversal. If not, the prospect of an inflationary monetary policy is likely to become an ever-more apparent threat, leaving bonds at present levels appearing highly vulnerable. **TM**