TrendMacrolytics

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FED SHADOW

Further Behind the Curve

Monday, December 8, 2003

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The jobs report can only reinforce the Fed's increasing recklessness.

For a **Fed** seeking to put off as long as possible the "re-entry problem" of prepping the markets for an eventual policy shift without sparking a major bond market rout, Friday's weaker-than-expected employment report couldn't have been better timed. The seemingly still-sluggish payroll numbers should give the central bankers gathering for tomorrow's **FOMC** meeting all the excuse they need to sustain the "disinflation" justification for their hyper-easy stance while continuing to imply that current policy can be maintained more or less indefinitely. But as credit markets soared on expectations of a delay in the onset of rate hikes, the price of gold spiked by some $6 to $406, another new high for this rally. That amounts to clear warning that the longer the Fed avoids moving into a tightening cycle, the larger its inflation error is likely to be.

We think it a highly dubious proposition that the gain of 57,000 payroll positions -- versus consensus expectations of 150,000 -- represents any real slackening of this recovery, or provides the Fed with cover from the need to begin lifting rates. For one thing, payrolls have grown by 328,000 since July, the largest four-month gain in nearly three years. In addition, the **California grocery workers** strike contributed a net loss of about 27,000 jobs from the payroll total. Most significant, though, forward-looking elements of the jobs report suggest both continued economic strength and sustained labor market recovery. Temporary workers grew by 21,000 for the seventh consecutive monthly gain, while aggregate hours worked are rising at a 2.6% rate on a three-month moving average, highest since mid-2000.

Even prior to release of the monthly jobs data, however, the Fed was sending clear signals that it remains content to stand pat. In their public appearances and press interviews over the past several weeks, a bevy of Fed officials have sung from the same hymnal: with the supposed "output gap" continuing to hold down inflation pressures, there is yet no reason to seriously contemplate policy change. **Vice Chairman Roger Ferguson** perhaps best captured this mindset, suggesting that "inflation still seems more likely to move lower than to increase. Under these circumstances, the central bank has the luxury to monitor events before it has to confront the need to return the stance of policy to neutral position."

At the same time, the ***Washington Post's*** long-tenured Fed correspondent **John Berry** had a piece in Friday's paper -- published prior to release of the jobs report -- that seemed intended to shoot down any speculation tomorrow's meeting would bring substantive change. Berry cited Ferguson's and similar remarks by several other Fed notables, and recounted that the wording of each FOMC statement since the August meeting has "emphasized that the central bank has been more concerned about a further drop in inflation than about any acceleration." He also noted that since October the statement suggested rates could stay low "for a considerable period." Referring to "many analysts" who expected that phrase to be dropped from the statement tomorrow, Berry offered: "That could happen, but appears unlikely. More important, even if the language were changed, it would not signal an imminent rate increase." Berry didn't

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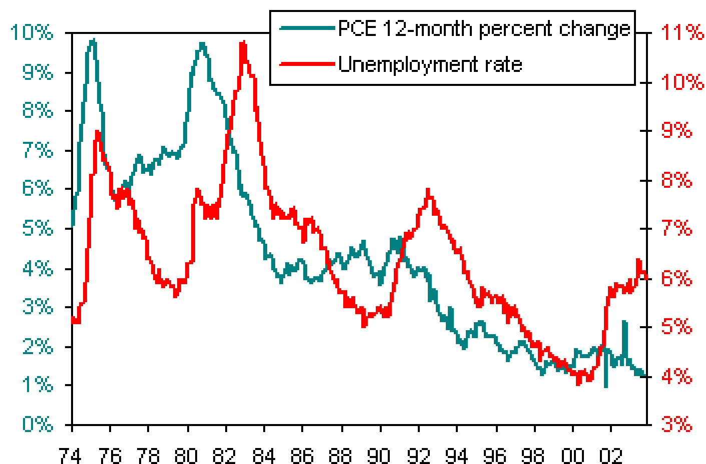
directly quote Fed officials on this score, but given his long-established and widely known status as the senior Fed staff's favored messenger, it's unlikely that he'd offer such conclusions simply as an independent observer.

Key to the Fed's relaxed attitude, of course, is the belief that in the absence of job gains sufficient to push unemployment considerably lower, inflation is a dead letter. Berry recited the familiar rationale, averring that "based on the…nation's combination of relatively high unemployment and extremely low inflation, an increase in the central bank's key 1 percent target for overnight interest rates appears unlikely for many months." The notion dies hard, but the idea that the risk of sharply higher inflation is impossible without tightening labor markets causing higher wages is dangerous **neo-Keynesian** drivel, discredited by decades of contrary experience.



The accompanying chart, plotting the unemployment rate against the core personal consumption expenditures price index, shows the theory directly contravened during periods of both sharply rising and falling inflation over the past 30 years. The accelerating inflation of the 1970s and early 1980s corresponded not with falling, but rising, unemployment. Likewise, the inflation deceleration seen in the mid-1980s and throughout the 1990s didn't coincide with rising unemployment, as the theory holds, but with plunging joblessness. In fact a simple statistical test, using a six-month lag, shows a substantially higher correlation coefficient with inflation as the regressor variable explaining subsequent unemployment (47%), than with unemployment explaining inflation (17%). In other words, causality is stronger running from inflation to unemployment than *vice versa*. A major component of the theory that animates so much conventional thinking about inflation and monetary policy is built on a fallacy.

Nevertheless, such theoretical armor must provide great protection against the slings and arrows of reality. We continue to be amazed that in nearly all commentary regarding the current policy framework -- both official and unofficial -- indications that inflation has already bottomed and begun to turn higher are roundly ignored. On a 3-month annualized basis, core PCE inflation is now rising at a 1.3% rate, up from a low of 0.7% last spring. We don't claim that a 1.3% inflation rate is anything to be alarmed about. But with the continued erosion of dollar purchasing power seen in sensitive, forward-looking market indicators such as gold and foreign exchange, the trend from here is considerably more likely to point higher than lower.

For now, Fed officials remain comfortably oblivious to such things. It could be, though, that comments last week by **OPEC** officials suggesting the cartel could raise oil prices due to the dollar's fall on forex markets did not go entirely unnoticed at the central bank. While the monetary significance of gold and forex rates are an abstraction to all but a few current policymakers, anyone with a memory of the 1970s might not so easily ignore the musings of OPEC about setting prices to compensate for the loss of dollar buying power. Stagflation anyone?

Meanwhile, we are maintaining our **Model Positions short the June 2004 Eurodollar futures** contract and **short the 10-year Treasury**. Although this latest turn in the speculative

environment has moved against it, the June Eurodollar contract is still priced for a 75% chance of 50 basis points in rate hikes. We think potential in both short positions is likely to be realized as evidence of recovery and simmering inflation continues to build. In fact, the current Fed expectations environment can be seen as much like the one existing three years ago, only in reverse. At that time, the Fed continued to warn of the inflation risks arising from the "shrinking pool of available workers" almost up until the very moment when evidence of a sharply braking economy abruptly turned the policy posture toward ease. The forthcoming turn in expectations could be just as swift, with handsome investment returns available to those positioned to take advantage of it. TM