TrendMacrolytics

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FED SHADOW

What's He Thinking?

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Alan Greenspan wants inflation. The problem is: he's going to get more than he's bargaining for.

We spent last week visiting clients in **Texas**, covering the full range of political and economic issues affecting the current market environment. But the week's tone was perhaps best crystallized by an **Austin** portfolio manager, who asked: "What is Greenspan thinking?" Addressing this question, we think, could offer some timely insights into **the Fed's** present quandary.

Given his intellectual roots in classical monetary principles, and his oft-stated skepticism about adhering rigidly to an "output gap" policy model, **Alan Greenspan** is almost assuredly more cognizant of the inflation risks arising from the Fed's current posture than he has let on publicly. It's true that he made an apparent break with classical principles -- for public consumption purposes at least -- at about the same time he became preoccupied by concern with the market's "irrational exuberance," which set the stage for the Fed's deflationary error of 1999 to 2001. Still, we seriously doubt that the Fed chairman has blithely ignored recent movements in the price of gold -- the essential classical monetary indicator and the favored guidepost of his early tenure -- which is now trading in a volatile range above $415, after dipping below $400 for several weeks.

Much of the financial press continues to dismiss the gold price movement as a safe-haven response to heightened terrorism concerns in the wake of the **Spain** bombings earlier this month. It's not likely, though, that gold would maintain a safe-haven risk premium that has already washed out of asset classes such as equities and bonds. Rather, the gold price primarily has tracked shifting Fed policy expectations. Gold fell back after the statement issued at the late-January **FOMC** was seen as signaling that the central bank could move into tightening mode sooner than had been anticipated. But the monetary metal has largely regained that lost ground since the March 16 policy session again indicated that policy could remain on hold indefinitely due to concerns about the "lagging" pace of new hiring.

Greenspan's private interpretation of gold price behavior -- as well as that of other market-price indicators such as the dollar's forex value and TIPS spreads -- most likely differs from ours only by degree. Despite the dominance at the Fed of policy makers and senior staffers who worship at the altar of the output gap, Greenspan understands full well that the dollar's weakening by about 25% in the past year, and by nearly 50% in a little over two years, means that higher inflation lies ahead. He probably is mollified that, up to a point, the decline in the dollar's real purchasing power is a reflationary correction from the earlier deflation, and to that extent does not have direct inflationary consequences. Where that point is, however, is a matter of analytical interpretation, and no doubt he's granting himself some significant leeway on that score. For our part, we note that the current price of gold exceeds the 10-year moving average by some 25%.

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Such a divergence has not been seen since 1987, when it served as a precursor of the inflation breakout of the late 1980s.

But be that as it may, we believe higher inflation is exactly what Greenspan wants. He knows that at some point he will inevitably be moving the Fed into a tightening cycle, and thus his current inflationary posture can be seen as taking out a measure of insurance against the potential for deflation when that time comes. During his speech to the **New York Economic Club** early this month, Greenspan acknowledged what amounted to an epiphany when he came to the realization that deflation could not be ruled out as an impossibility under a fiat money regime. We can date that realization to the fall of 2002 when, after years of denying that a massively too-tight policy stance was imposing real deflationary pressures on the financial system, Greenspan and the Fed finally broached the possibility of a falling price level. At that time, the discussion was framed mostly in the context of assurances that the Fed was prepared to take all steps necessary to avoid that eventuality, including, if need be, injecting unlimited quantities of liquidity to root out the deflationary impulses and reflate the dollar.

The problem is that by the time the Fed made this belated discovery, the market-based indicators that we monitor suggested that the deflationary liquidity scarcity was close to being fully corrected. As we warned at the time, a central bank committed to vanquishing non-existent deflationary forces would, in essence, be sanctioning an inflationary policy thrust. At this point, Greenspan likely believes that he can limit the eventual inflation uptick to something in the realm of 2%, and probably doesn't think he's done enough yet to get there. Our best guess, though, is that he's already done too much, and that without fairly aggressive action starting soon, a period of CPI inflation running at annualized rates of at least 3% is an ever more certain eventuality. And the longer he waits, the worse it will get.