TrendMacrolytics

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FED SHADOW

Good News?

Wednesday, June 16, 2004
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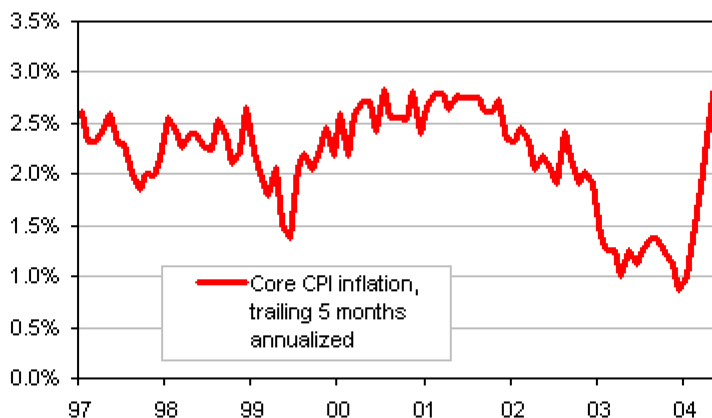
Small improvements in reported inflation only open the door for large policy error.

For all the celebration over yesterday's at-consensus 0.2% uptick in core CPI coupled with **Alan Greenspan's** reassurance that **the Fed** is prepared to take a "measured" approach to policy normalization, it's worth recalling that policy makers were still on deflation watch as recently as March. With their clear focus on the rear-view mirror, the monetary wizards still believed then that such non-monetary factors as weak reported job growth presented a greater risk of downward than upward price pressures.

Since then, of course, the rebound in payroll data eliminated the Fed's primary excuse for maintaining an excessively accommodative posture, allowing the market to price for as much as 150 basis points in tightening by year end. The Fed, however, has been a lagging rather than a leading actor in this process, hesitantly responding to market expectations and the badly lagging data. Most likely, that will continue to be the case, the central bank playing catch-up in a rising inflation environment.



Make no mistake, although yesterday's inflation data sparked a short-covering surge in a bond market fearing the worst, it did nothing to reverse trends that have become apparent in the past several months. Over the first five months of the year, core CPI is up at an annual rate of 2.9%, after rising by 1.1% all of last year. On a three-month annualized basis, core consumer prices continue to grow by 3.3%, the highest in nine years. And even a simple annualized extrapolation of yesterday's number standing alone puts core inflation, at 2.5%, above the 2% rate Fed officials cite as the upper bound of effective price stability.

Fact is, were the Fed to cap this still-modest inflation revival at 3% or so, it would hardly be the end of the world. Obviously, a bond market still clinging to sub-5% 10-year yields would suffer significant additional punishment, and would likely revisit levels approaching 6.5%. At the short end, Eurodollar futures now priced for a 4% funds rate by December 2005 would be underwater by at least 100 basis points. But it wasn't very long ago that 3% inflation was widely considered close to ideal, and was consistent with a robust economic and market environment.

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The clear risk, however, is that with its reliance on backward-looking indicators, the Fed slips even further behind the curve, and is rendered powerless to prevent the price level from ratcheting up at a significantly more accelerated pace. Monetary policy works on inflation only after lags that can range from one to two years, or even longer. In other words, whatever action the Fed takes now will have no effect on prices for at least a year. The effects of a long-standing surplus liquidity posture will continue to feed through the system long after the Fed begins to raise rates and sop up the liquidity excess. The most that can be done is to normalize its stance as expeditiously possible so that additional inflationary impulses do not become entrenched.

Therefore, to suggest -- as was widely speculated yesterday -- that a one-tenth of a percentage point dip in the reading on last month's core inflation gives the central bank leeway to be less forceful in raising rates is the height of folly. To act in line with such conjecture would risk serious monetary error. Unfortunately, there clearly are those at the central bank who are seemingly oblivious to the unavoidable lags, and perceive the role of monetary policy first and foremost as responding to current data. We continue to harbor hopes that a more seasoned approach will prevail, and the Fed at least will act no less firmly than called for by current expectations, which are priced for a year-end funds rate of 2.25% to 2.5%, rising to 2.75% by the end of next year's first quarter. At this point, however, we can offer no guarantees that such a course will be sufficient to preclude a sizeable inflation breakout. TM