TrendMacrolytics

Donald Luskin, Chief Investment Officer
David Gitlitz, Chief Economist
Thomas Demas, Managing Director

MACROCOSM

Oil: The Fed's Slippery Slope

Wednesday, August 11, 2004
David Gitlitz

The bond market is wrong if it thinks that oil is doing the Fed's tightening job for it.

As welcome as was the marginally hawkish posture taken by **the Fed** yesterday, countering speculation that disappointing payroll growth would markedly influence **the FOMC's** policy outlook, we are struck by the relative tranquility of the credit market's response. If the Fed remains as committed to maintaining the slow but steady pace of rate normalization as is being widely interpreted, it seems participants in the interest rate futures and cash bond markets haven't gotten the word.

In the two weeks preceding yesterday's policy meeting, futures markets had priced out 25 basis points of the 2.25% funds rate that had been expected by year end, and nearly 75 bps of the 3.75% rate expected by December 2005. Since yesterday's announcement, while both contracts have taken minor losses, they've held the bulk of the gains posted earlier. December '04 fed funds futures, for example, now show just a 21% chance of a 2.25% overnight rate coming out of the December FOMC meeting after 25 bp hikes at each of the two intervening sessions in September and November. Not surprising under the circumstances, long-term Treasuries have responded to the FOMC statement with equanimity, with the 10-year reversing just 5 bps of the 35 bp rally of the preceding two weeks. With a yield below 4.3%, the 10-year note is only about 10 bps above the levels of early April in the immediate aftermath of the March employment report, which first put the Fed in play to begin normalizing its 1% funds rate target.

What's going on? The apparent culprit in the signaling disconnect between the Fed and the fixed income markets is oil. We largely agree that the Fed went about as far as could be realistically expected in downplaying the policy significance of the soft jobs numbers. "Output growth has moderated and the pace of improvement in labor market conditions has slowed," the FOMC acknowledged. But, it added, "The economy nevertheless appears poised to resume a strong pace of expansion going forward," which under the Fed's murky communications rituals is about as clear an assertion as it could offer that the basic rationale for moving toward policy neutrality remains in place.

The problematic language, however, came in the sentence between these two when, referring to the slowdown in output and jobs, the statement allowed that "This softness likely owes importantly to the substantial rise in energy prices." For our purposes, it's an open question whether the Fed's purpose was to suggest that energy prices would be a factor mitigating against further rate hikes if their elevation continues to subtract from the strength of the expansion. It's at least plausible to think that the reference meant to offer reassurance that, absent the oil price spike, the underlying fundamentals of the economy remain strong.

Nevertheless, there's also no question that in the conventional view of the current policy environment, the focus is on oil price increases as a growth deterrent, appearing to counteract the need for monetary tightening. As one **CNBC** wag put it, "Aren't oil prices already doing the

http://www.trendmacro.com
don@trendmacro.com
dgitlitz@trendmacro.com
tdemas@trendmacro.com

Offices:
Menlo Park CA
Parsippany NJ
Charlotte NC

Phone:
650 429 2112
973 335 5079
704 544 6900

Fed's tightening job for it?" Or, as ***The Wall Street Journal*** maintained today in its news pages, if oil prices continue to ratchet higher, "the Fed would have to consider a halt to rate increases." This sort of thinking emanating from the fonts of conventional wisdom appears to be having a significant influence on credit market pricing.

In fact, we can imagine few scenarios that would have a more devastating longer-term impact on bonds than if the Fed were to accept the fundamentally flawed notion that higher oil prices offer a substitute for the need to impose a considerable degree of monetary restraint. As we have noted, the indications are clear that the Fed's excess liquidity posture has been an important causal factor in the rise of petroleum prices in the first place (see "Inflation: That 70's Show" August 2, 2004). Were the Fed to accommodate these price pressures -- which in themselves have a significant monetary source -- by maintaining an easier posture than it would otherwise, the consequences for inflation would potentially be on a par with the experience of the 1970s, when just such a calamitous policy error was committed.

Indeed, the post-FOMC chat group on CNBC yesterday included **William Ford**, who served part of his tenure as president of the **Atlanta Fed** under **Fed chairman Arthur Burns** during that era. Contemplating the very tricky ground the Fed is now treading on, Ford, with a certain haunted look in his eye, said he would characterize current economic conditions as "a slippery patch, not a soft patch." He went on to caution that the Fed would be extremely ill advised to let down its guard in the face of the oil price moves.

Our best assessment is that **Alan Greenspan** knows enough about Fed history to guard against overtly repeating the errors of three decades ago. He'd be unlikely, for example, to cut rates due to the affect of oil prices on growth, as was done in the early- to mid-70s. We don't have the same degree of confidence, however, that Greenspan understands that spiking oil prices could actually be an argument for accelerating the rate-normalization process given the Fed's extremely easy posture at the outset of this tightening cycle. In the interregnum between its ultra-easy stance and policy neutrality that will come only after rates are raised to at least 3%, the Fed will continue to be accommodative. That means seemingly exogenous price pressures such as are now being exhibited in oil can readily be "accommodated" in the overall price level.
TM