

MACROCOSM

Slippery Slope

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How much worse will the Fed let inflation risks get? And when will bonds take notice?

It may be too much to expect, but Friday's market action should have served as a forceful dose of reality for those consumed by false explanations for the dollar's slide as the inevitable comeuppance for the profligacy manifest in the **US** current account and budget deficits. After the November employment report printed with a marginally disappointing gain in payrolls, out-month interest rate futures rallied, the dollar sank to new lows against the euro and other major currencies, and gold rallied by more than \$5 to reach fresh 16-1/2-year highs above \$455. For anyone who cared to notice, these were all unmistakable signs of the real forces at work on the currency. They underscore the inflationary risk of a still too easy **Fed** becoming distracted from staying the course of monetary policy normalization in response to weaker than expected payroll growth.

Of course, these signs should be paid most heed at the Fed itself, where officials have seemed only too willing to point to deficits to excuse their own culpability for the dollar's weakness (see ["Passing the Buck"](#) November 22, 2004). We were encouraged by last week's report in the **Wall Street Journal** suggesting a growing recognition at the central bank of rising inflation risks. At the same time, though, the piece portrayed a rather casual attitude toward these risks, with internal discussion centering on whether, and when, to alter the language of the post-FOMC meeting statement that "upside and downside" risks to price stability are "roughly equal."

That such an obvious response to reality remains a subject of debate does not inspire great confidence that forthcoming Fed action will be sufficiently assertive to avoid entrenching the additional inflationary impulses represented by the dollar's recent weakness. As it is, our models indicate the Fed overstayed its hyper-accommodative stance at least one year too long, laying the foundations for an uptick of core inflation to at least 3% year-on-year, most likely within the next year. The open question now is whether policy will be tightened aggressively enough and expeditiously enough to keep the core rate from ratcheting even higher.

As we demonstrated previously, the dollar's value -- particularly its real purchasing power reflected in the price of gold -- has been highly sensitive to out-month expectations of Fed action seen in the Eurodollar futures market. Friday's pop in gold and the euro came as the December '05 Eurodollar contract knocked some 15 basis points off the short-term rate expected to prevail in one year, and is now priced for an overnight rate target of no more than 3.25%. Inasmuch as nine FOMC meetings are scheduled over the next year, starting with next Tuesday's, that expectation implies the Fed entirely skipping a 25 basis point rate hike at four of them. We regard that as highly unlikely and, in fact, attach a higher probability to the Fed at some point signaling its inflation concern by sanctioning a 50 bp move. From our perspective, then, a 4.5% funds rate by year-end '05 seems a distinctly more likely outcome than 3.25%.

At some point, as the market more clearly gleans the Fed's intentions, we'd expect the dollar to stabilize and potentially move somewhat higher. It is by no means assured, however, that such action will come soon enough to reverse the inflationary consequences of the dollar's 10% decline just since late summer. One thing seems fairly certain, however. Long-term Treasuries, which up until now have been content to follow the lead of short-rate expectations without pricing in a meaningful inflation premium, are destined to face a cold reckoning with reality when those expectations ratchet sharply higher and are compounded by the inflation reality that bond traders have so blithely ignored to this point. **TM**