TrendMacrolytics

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FED SHADOW

Retro Maestro?

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There's a growing number of clues that Alan Greenspan may be listening to price-signals again.

It has been many years since **Fed chief Alan Greenspan** professed any adherence to the market price indicators that were once integral to his policy framework. The end of the Greenspan price-rule era can be traced to the 1996-97 period when his regular public references to gold, foreign exchange and bond yield spreads as key signals were replaced by bemusing utterances about "irrational exuberance," "wealth effects" and other such *non sequiturs*. It's no mere coincidence that this rhetorical shift also marked the onset of the Fed's deflationary siege that would eventually wipe out the greatest era of wealth creation in modern **US** history.

But Greenspan's departure from a publicly acknowledged price-rule orientation doesn't mean that he has forgotten the classical lessons of economic history, which teach that inflations are always preceded by depreciation of the unit of account. Nor does it mean that he is now ignorant of the sensitive market indicators and what they are signaling about the decline of the currency's purchasing power. Up until recently, we suspect, Greenspan was not at all discomforted by the dollar's fall, seeing a moderate inflation uptick as a bulwark against the risk that the Fed's normalization of policy could trigger deflationary forces anew. After so long denying his deflation error, coming to terms with that reality a little more than two years ago was an epiphany for him. If somewhat higher inflation is the price to be paid for ensuring against a repeat, our bet is that he's more than willing to pay it.

Up to a point, that is. It appears that an important threshold was crossed late last month when the price of gold reached $450 for the first time since mid-1988, and as the dollar repeatedly set new lifetime lows against the euro. Within days, an apparently authorized leak suggesting "Fed officials believe inflation risks are on the rise" appeared in the ***Wall Street Journal***. Probably even more significant, however, a notable shift in the Fed's open market posture providing less liquidity to the market occurred at about the same time. While the arcana of open market operations can be open to varying interpretations, we believe it is no accident that the marginally more restrictive stance coincided with a more-than $20 decline in gold and the dollar's rally on forex markets. And while routine operations are normally handled by technicians on the Fed's **New York** desk, the abrupt change likely marked Greenspan's personal involvement.

Total assets on the Fed's balance sheet now exceed $780 billion, but the Fed effects market liquidity levels primarily through temporary repurchase agreements. In the last two years of extreme Fed ease, the desk has maintained repos at an average of about $25 billion per day, about $5 billion higher than prior levels. But beginning in late October, repos ramped up from $24 billion to a daily average of nearly $34 billion at the beginning of December. This period corresponded with the gold price moving from just above $420 to over $450.

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In the first full week of this month, however, the desk permitted some $5.5 billion in repos to unwind, and the gold price fell to $440. In the weekly statement period ending last Wednesday, covering December 9 to15, another $3.2 billion drained off. During this second week, gold dropped below $435, although it has since rebounded to just above $440. It's worth noting as well that during the second statement week of the month the desk tolerated a noticeable uptick in the funds rate, even though the week started five days prior to last Tuesday's **FOMC** meeting sanctioning a 25 basis point hike in the target rate to 2.25%. Last Monday, the effective funds rate for the day was 2.18%. Allowing the rate to trade more than a few basis points above target, even on the eve of a policy meeting widely expected to raise the target, is not usual procedure. In fact, following the November 10 meeting which moved the target from 1.75% to 2%, three days lapsed before the effective rate was brought *up to target.*

It seems clear that normal operating priorities were superseded to send a message that the Fed, in the person of Alan Greenspan, was not prepared to sit idly by indefinitely as the dollar tanked. It appears this message has also been received by market participants whose function it is to keep their ears closest to the ground with regard to likely Fed action. Since December 8, the implied yield on December '05 Eurodollar futures has ramped up by more than 20 basis points, to 3.62%, while the 10-year Treasury yield -- at 4.2% -- has gained only eight bps.

While encouraged by this turn of events, we are not yet prepared to conclude that the Fed now "gets it." Until we see convincing evidence suggesting otherwise, our hunch is that this has probably been a one-time adjustment to liquidity levels. Whether or not Greenspan understands that the liquidity excesses are a function of the Fed continuing to target below-equilibrium overnight rates, even at higher levels, remains much an open question. More likely than not, the Fed's open market desk will soon return to its operating routines, and surplus liquidity will again build up in the system until Greenspan sees fit to acknowledge the obvious -- that building inflation risks require a more aggressive approach. TM