TrendMacrolytics

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Dollar to Greenspan: "Show Me"

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Even bonds are beginning to see that a "measured" course isn't enough for the Fed.

It might seem a contradiction that even as speculation has intensified that **the Fed** is likely to do more, rather than less, to restore policy "neutrality," the dollar has sold off and gold has rallied back above $430 for the first time since late last year. It's true that over most of the past year variations in dollar strength have been broadly consistent with shifts in expectations for prospective Fed action. But at this point, it seems the dollar market is taking a "show me" stance, skeptical that even the marginally tighter policy now priced into out-month futures will be adequate to counter the increasingly apparent inflationary impulses of the Fed's still-accommodative posture. With the equity market tanking on the surge in crude prices back above $51 per barrel, we note that rising oil prices are largely a dollar phenomenon. In euro terms, the crude price has risen less than half the $4 seen over the last week.

A series of recent events appear to have brought matters to this juncture. **Alan Greenspan's Senate** testimony last week, in which he acknowledged that policy remains accommodative and pointed to the weaker dollar as a source of rising prices, was probably most significant. While Greenspan gave no solace to those hoping he would signal a forthcoming pause in the normalization process, neither did he attach much urgency to the task at hand. Core inflation, he said, has "remained low," and he gave no indication that a more assertive approach might be required. Following two days of hearings, December Eurodollar futures were priced odds-on for another 100 basis points in rate hikes, bringing the year-end funds rate to 3.5% -- but that was up only slightly from pre-testimony levels. Even at that, a 3.5% target by year end implies that policymakers would pass on raising rates at three of the seven remaining **FOMC** meetings this year.

The larger response came Friday, with the expectations-busting jump of 0.8% in core producer prices for January. At that news, the implied yield on December Eurodollar futures jumped more than six basis points, about twice as much as the net change after two days of Greenspan-speak. While some analysts discounted the core PPI surge as attributable in part to one-time events, if just half the 0.8% increase reflects underlying price pressures, it still represents a more inflationary environment than has been seen in many years. Extrapolated out to a full year, that implies a core PPI rate of nearly 5%. As it is, the year-on-year core rate at 2.7% is at its highest levels since 1992. The PPI, it also bears noting, is often a more market-sensitive gauge than the other official inflation indexes. The PPI was alone among the government's statistical price indicators in turning negative as a result of the Fed's earlier deflationary error, and was showing year-on-year declines as recently as mid-2003.

The PPI surprise also came on top of another release pointing to the weak-dollar effect on import prices. As Greenspan suggested they might, these higher prices are sticking, and can be seen as another front-end indicator of the price-level impacts of the Fed's excessively accommodative posture. Non-petroleum import prices are up at an annual rate of more than 3.6% over the past six month, and 6% over the past three.

Bottom Line: The reality of a behind-the-curve Fed, it seems, also is finally catching up with a bond market that has been far too complacent for far too long. The jump in yields has been most pronounced in longer maturities, with the 10-year benchmark -- now yielding just below 4.30% -- up more than 30 basis points in the past two weeks, compared to about 20 bps at the short end. As we have suggested, a stubborn denial of inflation risk was a key factor keeping the curve-flattening trade in vogue. With that denial apparently eroding, we look for a continued steepening trend. TM