TrendMacrolytics

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

FED SHADOW

Is Greenspan Getting It?

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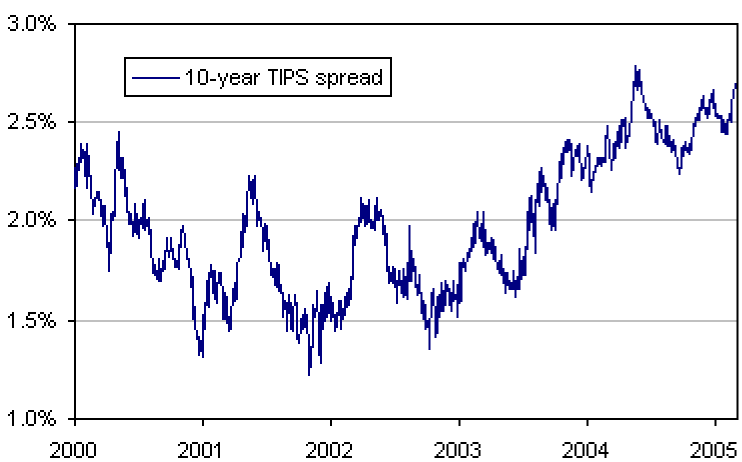
David Gitlitz

Still oblique, but Greenspan's inflation warnings are getting louder and clearer.

Alan Greenspan's House Budget Committee testimony last week garnered headlines -- and roused **Democrats'** ire -- for his favorable disposition toward **President Bush's Social Security** reform initiative. Totally overlooked by the media, however, were some revealing comments that have a much closer bearing on Greenspan's actual job description as **Federal Reserve** chairman. The comments indicate that Greenspan views the bond market as underpricing current inflation risk, which also suggests that out-month rate expectations continue to low-ball the likely pace and extent of this rate hiking cycle.

During the hearing, Greenspan was asked by a Budget Committee member to expand on his comments in mid-February that the bond market's behavior represented a "conundrum." Since then, we note, long-term yields have, on net, popped higher by nearly 30 basis points, with the 10-year note today nearing the 4.4% level. "The history of most of the programs of raising short-term rates by the Federal Reserve have in the early stages been matched by rising long-term rates," Greenspan explained. He suggested that this is "an almost arithmetically required relationship," because in the bond pricing process, the short-term rate controlled by the Fed is a component of longer-term yields.

It's only "toward the end of a tightening period, when it becomes clear that the impact is to restrain inflation -- that is historically -- you will find that increasing short-term rates does move longer-term rates down," Greenspan said. "And that's largely because the inflation premium embodied in long-term rates, by going down, will bring the yield down." But in this episode, he added, "we moved up and long-term rates went down far sooner than is typically the case."



Although it might seem odd to find the Fed chief in the position of guiding the market to price for higher inflation risk, it's difficult to avoid the conclusion that that's exactly what he was doing. Essentially, he's saying long-term yields don't normally go down in a rate-hiking cycle until Fed tightening has reduced inflation expectations, and in this case the Fed has not tightened nearly enough to do so. After his many years' tenure, Greenspan has a finely-honed facility for market-signaling, and we can be reasonably certain that if this weren't the interpretation he wanted put on his comments, he wouldn't have worded them the way he did.

Greenspan acknowledged at the conclusion of his response that since his earlier remarks "long-term rates have moved up and it's less of a conundrum in that respect." Indeed, it could well be that the market's move since the February testimony has gone some way toward alerting him to the risks at hand. Most striking about the bond back-up, which actually began the previous week after the 10-year Treasury yield bottomed at 3.98% on February 8, is the extent to which it has been attributable to a rise in the inflation premium. The spread between the nominal 10-year and the inflation-indexed TIPS "real" yield has bulged out to 272 basis points. That's some 25 bps above its levels at the market's February peak, accounting for more than 60% of the rise in yield.

Although there are several technical issues that limit the usefulness of TIPS as a true measure of the real yield, the TIPS spread can be seen as rough proxy for inflation expectations, one that Greenspan himself is known to watch. Following Greenspan's mid-February testimony, we described how market price indicators were evincing a "'show me' stance, skeptical that even the marginally tighter policy … will be adequate to counter the increasingly apparent inflationary impulses of the Fed's still-accommodative posture" (see "Dollar to Greenspan: 'Show Me'" February 22, 2005).

Why would Greenspan want to alert the market to price for a higher inflation premium? We can think of at least two reasons. First, if he sees bonds as badly out of line, guiding the market toward less overbought levels would reduce the risk of a potentially damaging break when reality hits. Probably even more important, though, subtly acknowledging the true inflation climate signals that Greenspan has no intention of aborting the rate-hiking process before the funds target has reached a non-accommodative level. At this point, December Eurodollar futures are fully priced for a year-end funds rate of 3.75%, 25 basis points higher than prior to Greenspan's first **Capitol Hill** appearance last month. However, that would still put the overnight rate target at a level implying that the Fed would pass on hiking rates at two **FOMC** meetings this year. We see that as increasingly less likely and, in fact, believe it more likely that the Fed will at some point sanction a 50 basis point move to signal that it is moving out from behind the curve.

Bottom Line: Greenspan's comments provide some reassurance that a more reality-based view of the inflation risk environment is gradually taking hold at the Fed. With gold today back above $440 for the first time this year, however, it's clear that more than signaling dances will be required to instill confidence that the Fed is committed to taking the steps necessary to restore a non-inflationary policy stance. For bonds, whether or not they are clued in to Greenspan's thinking, downside risk remains the dominant reality. TM