TrendMacrolytics

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About Time

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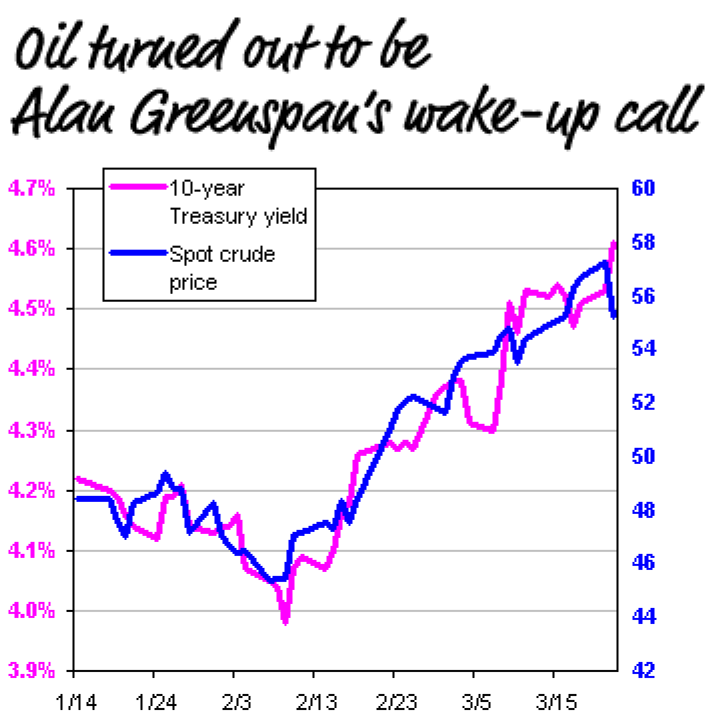
The Fed finally awakens to the inflation threat -- and in time to remain "measured."

As concerned as we've been about **the Fed's** dawdling response to the accumulating evidence of rising inflation risk, yesterdays **FOMC** statement was a bracing recognition of reality that likely will stand as a pivot point marking the initiation of a more vigilant policy approach. Reflecting the new outlook, the price of gold dropped nearly $5 on the news, crude oil turned lower, the 10-year Treasury fell more than three-quarters of a point sending the yield to a near nine-month high above 4.6%, and the December Eurodollar futures contract popped by some 14 basis points and is now fully priced for a 4% funds rate at year end. By contrast, just six weeks ago the futures were pointing to an overnight rate target between 3.25% and 3.5%.

"Pressures on inflation have picked up in recent months and pricing power is more evident," the Fed said in the most unmistakable signal of the central bank's altered state. While this language was bordered by happy talk that "longer-term inflation expectations remain well contained," and that rising energy prices have "notably not fed through to core consumer prices," the acknowledgement of current inflation reality represents a stark shift in perspective from the contented noises coming from policymakers just days ago (see "The Fed's Oil Slick" March 21, 2005.)



Our hunch is that this move bears the personal stamp of **Alan Greenspan**, who has entered the final year of his long tenure at the Fed's helm. While some of the luster on his once unassailable stature has been tarnished in recent years, preserving his legacy as the unmatched inflation foe has to be considered a strong motivation for him at this point. Countenancing a significant inflation breakout as his last act as Fed chairman, obviously, would not serve that end. In that regard, Monday's editorial by the ***Wall Street Journal***, "Greenspan's Real Mistake," likely was not an insignificant influence on him. Employing many of the same arguments that we have made over the last year, the *Journal's* editors

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warned: "The Fed is going to have to tighten money to get control of this incipient inflation, and the faster it does the less financial damage there is likely to be down the road."

Actually, as we have described, by detailing the mispricing of long-term bonds Greenspan already was at least subtly acknowledging the heightened inflation risk climate (see "Is Greenspan Getting It?" March 8, 2005). But no doubt, recognition of the need for more pronounced Fed vigilance has been driven largely by the spike in oil prices since early last month. As seen in the chart on the previous page, the track of the benchmark Treasury yield so far this year has very closely corresponded with crude prices. The impact of rising oil prices can be seen in terms of its effect on inflation expectations (the TIPS spread has followed the same trajectory in the same time frame), which transmitted directly to a heightening of Fed rate-hike expectations. Greenspan and his brethren could not ignore these market signals without sacrificing some measure of their credibility.

If was no surprise that stocks fell after yesterday's announcement. We've long forecasted a negative knee-jerk reaction in equities to such a palpable sea-change in the Fed's policy posture (see, most recently, "Inflation Now" March 14, 2005). But we continue to believe that such a reaction is misplaced, and will represent a buying opportunity once it runs its course (provided, of course, that worst-case threats to growth from the current policy disarray in **Washington** don't materialize -- but more on that later). Historically, stocks do well during those Fed tightening regimes in which rate-hikes are enacted as a prudent response to actual inflationary threats. Those tightenings are not expansion-killers that "take the punchbowl away" -- rather, by reining in inflation before it gets out of hand, they contribute to the durability of expansions. The risk to growth comes either when the Fed tightens specifically to slow growth down (as it did in the 1999-2000 tightening cycle), or when the Fed has gotten so far behind the inflationary curve that it must resort to shock therapy (as it did in the late 1970s). We were delighted to see the word "measured" remain in the FOMC's statement yesterday, because in concert with the Fed's new level of inflation vigilance, it signals -- correctly -- that inflation can be held to levels that are actually quite low by historical standards, and with an orderly sequence of rate hikes that will really represent little more than a return to normality.

Bottom Line: By signaling that it is prepared to take a more forceful approach to quelling the incipient inflation becoming evident in a widening variety of indicators, the Fed has taken an important step toward ensuring that the current price level uptick will be limited (although we continue to regard a 3% rate of core inflation as virtually assured). The market response to the Fed's change in approach indicates that downside risk to dollar purchasing power has diminished. This is further confirmation to our earlier intuition that the US dollar has put in its bottom on foreign exchange markets (see "A Dollar Rally?" January 4, 2005), which in turn will take some of the pressure off the dollar crude oil price. Relaxation of tensions in the oil market would be a powerful symbol of how the newly vigilant Fed can encourage, rather than threaten, the current expansion -- and is part of our argument for why it does not represent a threat to stocks. The bond market, on the other hand, still has some considerable reckoning with reality to do. Some inflation risk is surely off the table -- but that's little help to bonds, which were nearly blind to that risk in the first place. The operative factor for bonds is an expeditious -- if "measured" -- return of short rates to normal levels, bringing long bond yields inexorably back to normal, too. TM