

MACROCOSM

Onward to Normality

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The bond market just isn't listening if it believes the Fed is going to slow down.

After finally acknowledging at its most recent policy session less than two weeks ago that "pressures on inflation have picked up," is **the Fed** now poised to tack back again toward complacency due to a month of "disappointing" payrolls data? Not likely. Notwithstanding their allegiance to the deeply flawed output-gap/**Phillips Curve** doctrine which posits relative labor market tightness as key to the inflation outlook, even Fed officials face limits in the degree to which they can ignore economic reality. As bonds finished a double-whipsaw session Friday with a gain of nearly a quarter point on supposition the weakish jobs report will retard both the pace and extent of the policy normalization process, two regional reserve bank presidents gave notice of a new cognizance of inflation risk.

Coming in the midst of all the happy talk in the financial press that the March addition of just 110,000 jobs to payrolls would keep a lid on the Fed, the remarks of **William Poole** and **Cathy Minehan** -- presidents of the **St. Louis** and **Boston** Fed banks, respectively -- were widely ignored. Their comments, however, suggest it would be a mistake to downplay the Fed's perception of the task still facing it. "The upward thrust to the economy appears quite substantial and the risk of higher inflation over the next six months or so seems clearly greater than the risk that inflation will fall below a desirable range," said Poole, a monetarist sometimes considered an inflation "hawk," but who has rarely ventured outside the Fed consensus. "Monetary policy should ensure that inflation pressures do not get built into inflation expectations," he added, and then went on to suggest that an uptick of inflation from current levels already is inevitable: "The aim of monetary policy should be to counter inflation pressures with a less accommodative policy stance, so that higher actual inflation does not extend beyond unavoidable transitory effects." For her part, Minehan said upside inflation risk remains "modest," but nevertheless suggested that implies "less need for policy accommodation."

Curiously, while the credit markets chose to disregard the implications of these policymakers' statements, it appears that the markets most sensitive to factors affecting supply and demand for dollar liquidity -- gold and foreign exchange -- did not. Gold closed Friday down nearly \$3, at just above \$425, is continuing to fall today to around \$423, and is down nearly \$20 in the past three weeks. Against the euro, meanwhile, despite the incessant nay-saying of current account and budget deficit obsessives, since mid-March the dollar has rallied from below \$1.34/€ to around \$1.28/€, and is today holding a gain of another 0.4% versus the **European** common currency.

To be sure, the strengthening of these indicators of dollar purchasing power are welcome signs that the worst-case inflation bets arising out of the Fed's too-easy-for-too-long policy stance are steadily being tempered by the central bank's apparent adoption of a more responsive and vigilant approach. Still, considerable risk pertains in the current environment and should not be overlooked. With a 2.75% funds rate target, the Fed is still easy. While debate rages over the

point at which policy can be considered "neutral," few if any credible analysts put it below 3.5%. Given system-wide opportunity costs in the current robust economic expansion, our estimate of a policy-neutral rate is closer to 4.5%. In the meantime, the Fed is continuing to supply the excess dollar at the margin, which means it is continuing to inflate, even while lifting rates 175 basis points since last June. The risk is heightened further in the context of still escalating crude oil prices. On the one hand, as we have noted, the higher crude price already reflects a significant element of dollar inflation. The greater danger, however, is that in an easy-money environment, rising oil prices can be accommodated in the general price level, essentially forming the foundation for an inflation breakout to sharply higher levels.

As it is, the trends are already unmistakably pointing higher even in the deeply lagging, backward-looking official inflation indexes. Last week, the report of a 0.2% monthly increase in the core PCE deflator ("**Greenspan's** favorite") was widely interpreted as a benign reading well within the Fed's comfort zone. While the 1.6% year-on-year increase is certainly no cause for alarm, a closer look suggests somewhat less comfort might be warranted. On both a three month and six month annualized basis, core PCE is now running at 2%, after bottoming at less than 1% in late 2003. This would also be nothing to be terribly concerned about if we could be confident that after doubling in little more than a year, the pace was likely close to topping out. We can offer no such confidence, however. As the effects of monetary policy are reflected in the price indexes only after a lag of 18-24 months, it's likely that the effects of a good part of the Fed's most accommodative liquidity stance have yet to feed through the system.

Bottom Line: The bond market's renewed attempt to rally on the notion that the Fed can afford to do less in normalizing rates due to less than vigorous payroll growth has pushed the 10-year benchmark back below 4.5%, but appears again to put the market in badly overbought territory. With Fed officials for the first time in this cycle clearly conceding that inflation risks are on the rise, any bet on a truncated rate-hiking schedule appears unjustifiable. The more relevant risk at this point is that a behind-the-curve Fed has failed to sufficiently ward against a more significant inflation breakout, requiring that rates ultimately would need to go significantly higher than would be implied by simply restoring "neutrality." **TM**