TrendMacrolytics

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FED SHADOW

Greenspan's Conundrum

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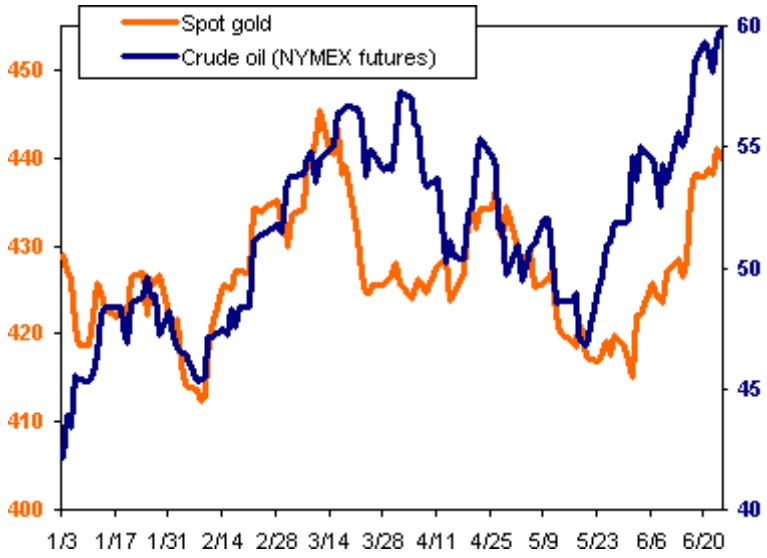
Oil prices put the Fed on notice: this is no time to be flirting with a less vigilant stance.

With **gold** at $440 and **crude oil** at $60, **Alan Greenspan** no doubt has developed a greater appreciation for the **"conundrum"** concept than he could have imagined when he introduced the word to the economic/financial lexicon in early February. As the **bond market's** latest rally attests, the current consensus is that **weaker growth** is the primary risk posed by the renewed oil price escalation, another in the long series of rationales backing the bond bulls' wishful thinking that **the Fed's** year-long **rate normalization** campaign is nearly done.

A continued march higher in crude prices would indeed pose a threat to the expansion at some point, and might -- all else equal -- justify an earlier end to the **rate-hiking cycle**. All else is not equal, however, and therein lies Greenspan's conundrum as he prepares for this week's **FOMC** session. Gold, which has risen by some $25 (6%) since the beginning of the month, is signaling that this would be exactly the wrong time for the Fed to indicate any departure from its current course, a message Greenspan cannot afford to ignore. To considerable extent, in fact, this gold price move appears closely tied to the **policy risks** posed by rising oil prices.



As seen in the chart at left, there has been more than a casual correspondence in the movements of gold and crude this year. At one level, this reflects that a non-trivial factor in the oil spike has been the same **inflationary** weakening of **real dollar purchasing power** seen in the gold price rise of the past two years. In spring 2003, prior to the Fed entering the ultra-accommodative phase of its easing cycle, gold traded in a range around $325 and oil was still below $30.

The chart indicates, however, that a different dynamic has been at work in this most recent run-up in crude and gold. Gold jumped off its recent lows around $415 only after oil had climbed nearly $10 per barrel through late May, to around $55. This suggests that speculation that rising crude prices would restrain Fed policy normalization, keeping the central bank in a surplus liquidity posture, has been the key driver pushing gold higher. The late May oil price move also corresponded with out-month expectations for the **fed funds rate** falling by nearly 25 basis points to 3.5%, as seen in trading on the **December '05 Eurodollar futures** contract. In the weeks since, the implied yield on the December contract has backed up some,

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and now shows essentially an even-money bet on whether the funds rate target will end the year at 3.5% or 3.75%.

We find arguments supporting the notion that higher oil prices justify the Fed at this week's meeting tilting toward a **less assertive posture** barren of substance. First, the concern about current crude prices representing a threat to the expansion has been significantly overdone. While $60 is a record in nominal terms, it is still nearly 30% below early-1980s prices in real terms. Moreover, with **efficiency improvements** and **fuel substitution** in the intervening years, the economy is more than 25% less **oil-intensive** than it was then. Again, rising petroleum prices would at some point pose a substantial obstacle to continued growth. But there is little to suggest that that point has yet been reached. To the contrary, the market-based indicators we monitor suggest the economy remains on firm ground. Perhaps the most compelling confirmation of this fact was the recent **Treasury** data showing **individual income tax** receipts up more than 20% year-on-year. Such a revenue surge outpaces even the boom years of the **Reagan** and **Clinton** administrations.

For the Fed's purposes, moreover, a preoccupation with the supposed growth implications of rising oil prices would be fraught with peril. As indicated in every FOMC statement for the past two years, monetary policy remains **"accommodative."** On the one hand, that is meant to signal that the Fed still sees policy as being growth-friendly. But it also amounts to an acknowledgement that money is still easy. In the 1970s, an **easy-money** Fed accommodated a series of oil price shocks, producing the worst **US** inflation in more than a century.

That event, it's safe to assume, remains seared in Greenspan's memory, since he witnessed most of it first hand from his perch as chairman of the **White House Council of Economic Advisors**. Although he no longer publicly discusses it in the policy context that he used in the first decade of his tenure at the Fed, it's also safe to assume that Greenspan knows the message being sent by the dollar's slide against gold. But among other policy makers, few of whom take any notice of gold, the dollar's apparent recent strength against foreign exchange, particularly the **euro,** may provide a false sense of confidence. As we have noted, after reliably tracking with the dollar's real purchasing power indicated by gold over the past two years, heightened political risk in the **Eurozone** has significantly dented confidence in the continental currency. The dollar's ostensible strength against the euro is simply a reflection of that currency weakening even more in real terms, *i.e.* against gold, than has the dollar.

All told, the interplay of forces within the Fed policy committee are likely to produce a statement Thursday showing very little apparent change in outlook with the confirmation of another 25 basis move higher in the funds rate target to 3.25%. There's little doubt that there are panelists sympathetic to the view that the Fed ought to be signaling than an end to the rate-hiking process is in sight. Others however, most importantly including Greenspan, likely are increasingly wary of the inflation risks implied by the oil price spike in combination with a still-easy policy posture, and will avoid giving any indication that the Fed is taking a less vigilant approach.

Bottom Line: To the extent **Treasuries** have rallied again, with the **10-year yield** back to levels around 3.9%, on hopes for a dovish signal from the Fed this week, the market is likely to be disappointed. We look for the FOMC to maintain the key features of its recent statements, including an acknowledgement that policy remains accommodative, that rate hikes can be maintained at a **measured** pace, and that inflation pressures have picked up. TM