TrendMacrolytics

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How Much Longer?

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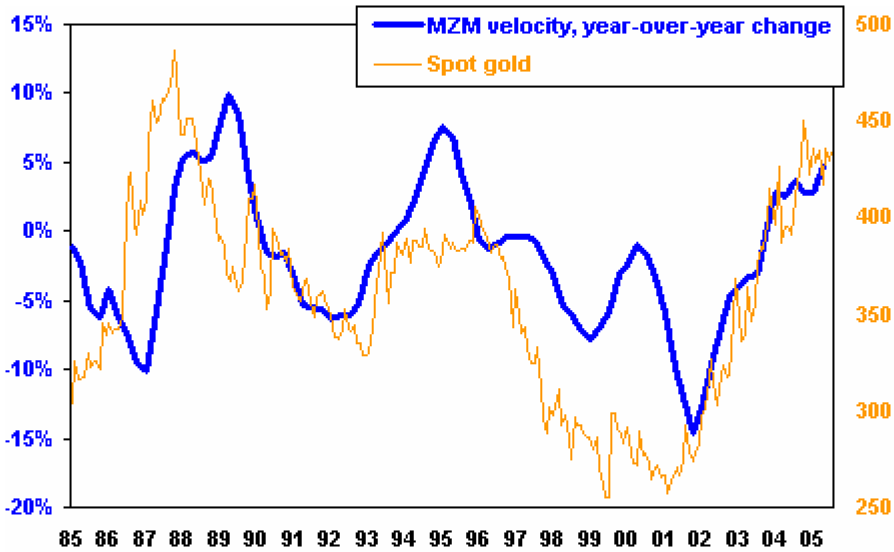
Markets are finally anticipating no Fed pauses this year -- but that may not be the end of the hiking cycle.

Having now lifted **rates** at 10 consecutive policy meetings, **the Fed** has seemingly traversed a considerable distance toward **normalizing** its stance from the **hyper-accommodative posture** that prevailed with a 1% **target rate** until mid 2004. With its new 3.5% rate target, the central bank certainly is not nearly as loose as it was at the outset of this exercise, and likely is well more than halfway toward the objective of reaching a **neutral, noninflationary stance**. By a host of measures, however, it's clear that policy remains **easy**, a fact that the **FOMC** continues to recognize. But the **dollar's** latest softening against **foreign exchange** and **gold** also suggests the task still facing the Fed could be more extensive than even the recently reality-checked **futures market** expectations suggest.

Credit markets breathed a sigh of relief after yesterday's FOMC statement fell short of their worst-case fears of hawkishness. For our purposes, though, the announcement was about as hawkish as one could realistically expect given the institutional and political constraints under which the Fed operates. There had been some pre-meeting speculation that yesterday might see ground being laid for the possibility of a 50 basis point move at a forthcoming session. But considering the extensive care with which the Fed has molded market expectations in this **rate-hiking cycle**, such an out-of-the-blue shift was probably a non-starter.

We saw as more significant the statement's acknowledgement that **inflation risk** remains a highly salient factor for the policy panel. While noting that "core inflation has been relatively low in recent months," and repeating that "longer-term inflation expectations remain well contained," the committee also saw fit to include the phrase that "pressures on inflation have stayed elevated." In the context of a sentence that otherwise could be read as suggesting less need for concern about inflation, the phrase almost seems out of place. But the fact that the language was included in that context seems intended to convey that policymakers still have significant concerns about inflation going forward. Playing a significant part in that most likely was the recent upward revision to the inflation index favored by the Fed, the **core PCE deflator**, which is now running at about 2% year-on-year, versus the 1.6% rate seen prior to revision. Not only is 2% the top of the range of the FOMC's "central tendency" forecast for this year, it is also regarded as the high end of the Fed's "comfort zone" with **core inflation**.

This inflation index popped higher late last year, running at 2.3% year-over-year in November, double its levels of a year earlier. But while the core PCE measure has subsided some in the intervening months, we think it unlikely that this is another trend reversal likely to be sustained absent further significant policy action. Viewed against the core PCE index, the new 3.5% funds rate target is some 100 basis points below its long-term real average of around 2.5%. Low real rates have historically been associated with reduced **demand** for money, rising monetary **velocity** and ultimately higher inflation.



The chart at left plotting **MZM velocity** against gold indicates that this dynamic is already at work. In keeping with a higher price of gold indicating an excess **dollar supply** relative to demand, velocity has trended markedly higher. To those suggesting that significant comfort can be taken from the recent inflation data, it's instructive to compare recent experience with the last sizeable inflation breakout in the late 1980s. Even as velocity, following on the heels of the steep gold price move, moved sharply higher through 1987, core PCE inflation remained roughly stable around 3.7%. Those inflationary impulses, however, did not fully feed through the system until as much as three years later when the index topped out at more than 4.5%, by which time gold and velocity had fallen sharply from their peaks.

Bottom Line: The Fed's move to a 3.5% fed funds target does not alter the fact that policy remains easy and has still has further to go to reach neutrality. Futures markets are now pricing for a year-end target rate between 4% and 4.25%, up from expectations of 3.5% to 3.75% in late June. But the recent slide in the dollar's **real purchasing power** seen in the price of gold trading in ranges around $435, up from below $420 in mid-July, suggests that even were these more hawkish expectations to be realized, it may not be sufficient to staunch the incipient inflation now working into the system. TM