TrendMacrolytics

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FED SHADOW

Time for Change?

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The Fed might be approaching neutrality, but that doesn't mean it's done.

Tuesday's **FOMC meeting** will undoubtedly produce another 25 basis point **hike** in the **fed funds rate target**, marking the 13th consecutive session at which **policy** has been nudged toward a less **easy posture** since the **normalization process** began 18 months ago. With a new target rate of 4.25%, however, **the Fed's** policy stance is moving into a zone raising new questions about the policy outlook. The language of each **post-meeting statement**, suggesting that policy remains **accommodative** while maintaining that accommodation can be removed at a **"measured"** pace, has provided essential predictability about the policy course up to this point. But as it becomes more debatable how accommodative policy remains after 325 basis points in rate hikes, that formulation has probably come close to outliving its usefulness. A heightened degree of uncertainty is likely now as the central bank refashions its **signaling approach** regarding the policy outlook.

The Fed's **communication strategy** for this cycle, characterizing its first objective as removing policy accommodation, made it inevitable that this situation would eventually come to pass when the rate was pushed up to a level that was no longer clearly accommodative. It was presaged in the **minutes** of the November 1 meeting, published three weeks later. "Several aspects of the statement language would have to be changed before long, particularly those related to the characterization of and outlook for policy," the minutes said.

Release of the minutes immediately sparked speculation that any change in language would amount to a declaration of an end to this rate cycle, and the **credit markets** continue to retain a bid based in part on such speculation. We find the proposition dubious, however. First, there has been no indication of a shift in policy perspective from within the ranks of the Fed itself. Were **officials** seriously contemplating a meaningful alteration in course, it would be signaled in some way in their public statements. To date, there has been no such signal. **San Francisco Fed president Janet Yellen** last week noted that there would come a time when the post-meeting statement's references to "accommodative" and "measured" were no longer appropriate, but said "it seems unlikely that the end of the tightening phase is yet at hand."

Over the course of this campaign, it has been widely assumed that the Fed was aiming to arrive at a **"neutral"** rate, and would know it when it got there. Both notions, however, were cast into considerable doubt this week by **Alan Greenspan**, who in the final two months of his long tenure as **chairman** has not lost his zest for upsetting easy assumptions. "A variety of definitions of a neutral real interest rate are possible," Greenspan said in written responses to questions from the **Joint Economic Committee**. "It is impossible to know with any certainty when the neutral rate has been reached." Moreover, he added, in some circumstances "—particularly when inflation is too high or too low -- aiming for a neutral funds rate in the near term would not be appropriate." Applying these observations to current conditions, it can be reasonably inferred that while the target **overnight rate** is reaching a point that can be

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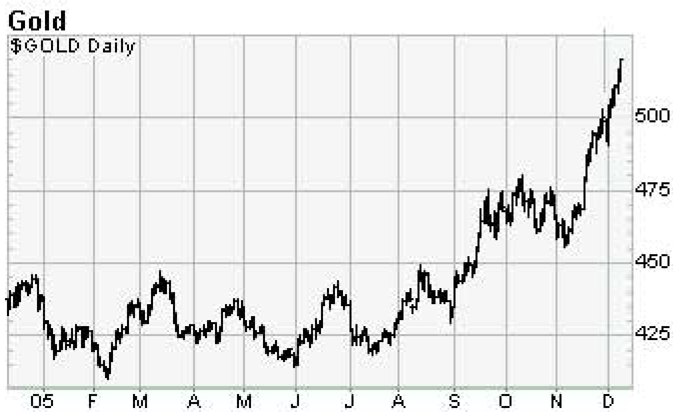
considered in the range of neutral, there is no reason to believe policymakers are persuaded it is yet approaching the "right" level. Indeed, with **core inflation** at the top end of the Fed's 1% - 2% **"comfort zone,"** it could well be that policy will aim for a measure of insurance. That's especially the case since from the perspective of the Fed's **demand-based output-gap framework**, the **economy** is currently seen expanding at **"above potential" growth rates**, pointing toward higher **inflation risk**.



From our perspective, using a model grounded in **market-based indicators** of **monetary value**, this would be exactly the wrong time to contemplate a cessation of the rate cycle. Indeed, the continued eye-popping rally in the most sensitive and reliable of those indicators -- **gold** -- can probably be attributed in some measure to questions surrounding the Fed's continued commitment to root out the inflationary impulses of policy. The **mainstream financial media** largely ignores the gold price as a forward-looking signal of **dollar purchasing power**, but the evidence of lurking inflationary danger is not limited to the yellow metal. The **Dow Jones AIG Spot Commodity Index**, up 30% since last May, is now at all-time highs, as is the **CRB Metals Index**.

One issue that cannot be overlooked as a factor in the monetary risk environment is the pending transfer of leadership at the Fed. The straight-line shot higher in gold to $525, from a range below $470, began the day after **Ben Bernanke's** confirmation hearing in mid November. Our impression of Bernanke at that hearing was that while he outlined a conventional, sub-optimal approach to policy, his approaching **chairmanship** does not necessarily entail a greater degree of risk than has been endured for the past 18-plus years under Greenspan. The market, however, may be testing the mettle of the incoming Fed chair, which could require that Bernanke take an even tougher approach than he now has in mind when he enters the marble corridors of the central bank in early February. In any case, at this point we are sticking with our forecast that Greenspan will bring the funds rate to 4.5% as his last act in office on January 31, and that the policy panel will sanction rate hikes in two of Bernanke's first three meetings, bringing the rate to 5% by mid-year.

Bottom Line: The Fed's rate-hiking cycle has reached a point where it is debatable whether policy remains "accommodative." The Fed has signaled that at some point fairly soon, a change in the language of its post-meeting statements regarding the policy outlook is likely. While this has sparked speculation that an end to the Fed's rate program could be in sight, it's more likely that policymakers continue to perceive the need to remain on the current policy course. TM