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Right Thing, Wrong Reason?

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The Fed gets it right again -- by accident. But the risk of major error is increasing.

Update to strategic view

FED FUNDS: 25 basis point hikes at each of next two FOMC meetings.
STOCKS: Yesterday's affirmation of Fed hawkishness in the FOMC meetings is a strong positive, but a data-dependent Fed on a verge of policy error is a recipe for more volatility.

For the bulk of this rate-hiking exercise, we have characterized the Fed as doing the "right thing for the wrong reasons." Our view was that the Fed's excessively accommodative posture of the past several years had weakened real dollar purchasing power and introduced inflation risks that required a sustained policy response. This accorded with the central bank's demand-based judgment that after keeping rates so low for so long, restoration of sustained solid economic growth risked putting "resource utilization" rates in the inflation danger zone, and a course of policy normalization was the obvious response. Even though it was operating from the deeply flawed Philips Curve output-gap model, it was easy enough to give the Fed the benefit of the doubt when there was no question that the funds rate target still needed to go higher from its 1% starting point nearly two years ago. But with the overnight rate now in a range that arguably can be considered "neutral" at 5%, the policy environment is beset by growing uncertainty, and the opportunity for Fed error is rising. The equity market turbulence of the past several weeks can be seen as a manifestation of the risks now arising from the available policy options, with the acumen of the Fed's still-new chairman Ben Bernanke being put to an early test.

The source of much of this anxiety has been the Fed's self-described posture of "data dependence" in determining its policy outlook. For the most part, given the existing circumstances, we were inclined to viewed this positively, seeing it as offering assurance that as long as growth remains vigorous -- which we expect -- the Fed is unlikely to conclude the policy normalization process prematurely, short of reaching equilibrium. There is a point, however, beyond which a data-dependent Fed becomes prone to the same errors that have often arisen from its demand-management paradigm. Relying on backward-looking official data rather than forward-looking market prices, the Fed inevitably puts itself in the position of attempting to fine-tune real economic outcomes rather than focusing on the only function which its policy tools leave it capable of reliably affecting -- the real value of the unit of account.

In the current context, the Fed's approach is giving rise to a double-edged set of risks. On the "hawkish" side, the possibility that the Fed will remain in rate-hiking mode until it sees clear evidence of a substantial deceleration in growth cannot be dismissed. The minutes of the May 10 FOMC meeting released yesterday underscored that risk. The minutes portray the policymakers as showing considerable concern about the recent uptick in core inflation. But rather than recognize that the rise in the statistical inflation measures reflects the lagged effects of the Fed's long-standing easy money posture finally feeding through the price system, the panel essentially attributes it to the economy's recent strength. In discussing factors contributing

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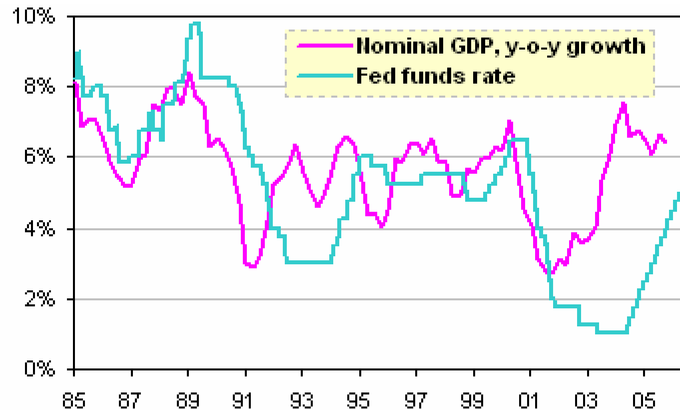
to upside inflation risks, the minutes assert that the "economy appeared to be operating at a relatively high level of resource utilization and had been growing quite strongly, and whether economic growth would moderate to a sustainable pace was not yet clear." The policy record further states that with "modest further policy action, including a 25 basis point firming today," it seemed likely that "growth in activity would moderate gradually…pressure on resources would remain limited, and core inflation would stay close" to recent levels. The Fed, then, is counting on a slowing in growth to relieve the revived inflation pressures. In fact, though, it's far more likely that reported core inflation will continue to move toward a year-on-year level of around 3%, regardless of growth, due to the Fed's years-long stance of monetary accommodation.



Up to a point, this apparently hawkish bent is certainly preferable to openly broaching the possibility of a pause in the cycle. We continue to maintain that the first order of monetary business is to bring policy to equilibrium to root out the inflationary impulses that remain evident in market price indicators such as commodities -- especially gold -- and the dollar. Viewing the fed funds target relative to nominal GDP growth, as seen in the accompanying chart, suggests that -- at current nominal GDP growth rates -- the Fed would have to raise rates by as much as 200 basis points before policy could be considered "restrictive," penalizing growth. We see it as unlikely that the Fed will feel compelled to continue raising rates to that extent. And we think it's likely that policy equilibrium will be reached at some point in the range of 5.5% to 6% on the overnight rate target. Thus, despite the undoubted overshoot risks that have recently been heightened, it remains more likely than not that the Fed will -- by hook or by crook -- get it right, rooting out the inflationary influences without crushing growth.

Ultimately, the greater risk of the worst case outcome would come if the FOMC's "doves" gained the upper hand, forcing an end to this policy cycle before equilibrium is reached. That cannot be ruled out either. In yesterday's minutes, it was clear that there is a faction on the committee that believes the Fed has already done enough. Their hand could be seen in a passage maintaining that the "cumulative effect of past monetary policy actions and the recent rise in longer-term interest rates on housing activity and prices could turn out to be larger than expected." But despite much recent commentary to the contrary, it's not at all clear that stocks would welcome the prospect of the Fed pausing -- or ending -- this policy cycle in the near term. In the midst of last week's bond rally on speculation that slowing growth will soon force the Fed to the sidelines, equities still got hammered. If the Fed stops too soon, inflation will ratchet even higher than the levels we now expect, inevitably prompting an aggressive tightening campaign that would in all likelihood put an end to this expansion.

BOTTOM LINE: In the wake yesterday of release of the May 10 FOMC minutes, the futures market upped the odds on a June rate hike from less than 60% to nearly 75%, and the price of gold fell nearly $20 to below $630, its lowest level in more than a month. To the extent the tilt toward hawkishness puts paid to the notion that the Fed is poised to pause or put an end to this cycle near-term, we regard it as a positive development. But a "data-dependent" Fed is courting a degree of uncertainty about the policy outlook that will continue to contribute to heightened levels of market volatility in accord with the increased risk of Fed policy error. TM