TrendMacrolytics

Donald Luskin, Chief Investment Officer
David Gitlitz, Chief Economist
Thomas Demas, Managing Director

FED SHADOW

Fed Roulette

Friday, June 30, 2006

David Gitlitz

The FOMC wants it both ways on growth and inflation -- but its ambivalence puts both at risk.

Update to strategic view
FED FUNDS: The June 29 FOMC statement opens the possibility of a pause at the new 5.25% level, but we still think one more rate hike is forthcoming at the next meeting. **US STOCKS:** Yesterday's rally validates or view that the recent dip has been a buying opportunity. But stocks will be on more solid ground for a sustained upside when indicators of inflation expectations, such as gold, confirm "mission accomplished" by the Fed.
[see Investment Strategy Dashboard]

The FOMC yesterday offered up a grab-bag of rationalizations and potential hints about its policy outlook. According to the equity markets, they add up to a growing likelihood of a pause at the newly established 5.25% target. And according to the response of sensitive market price indicators such as gold and the dollar, they entail increased risk of an inflation error. The eventual Fed response to such an error would entail a serious risk to growth.

While chairman Ben Bernanke has gone to considerable lengths over the past several weeks to shore up his -- and the Fed's -- credibility as unquestionably viewing inflation-fighting as Job One, it's at least arguable that yesterday's post-meeting statement represented a shading back toward putting growth in the lead as the chief concern. "Recent indicators suggest that economic growth is moderating from its quite strong pace earlier this year," the statement said. Following its May meeting, the Fed had said it saw "growth as likely to moderate."

At the same time, though, yesterday's statement acknowledges that "readings on core inflation have been elevated in recent months," and the perceived moderation in growth has not erased the concern that "high levels of resource utilization and of the prices of energy and other commodities have the potential to sustain inflation pressures." And while suggesting that "the moderation in the growth of aggregate demand should help to limit inflation pressures over time," the Fed said it also "judges that some inflation risks remain."

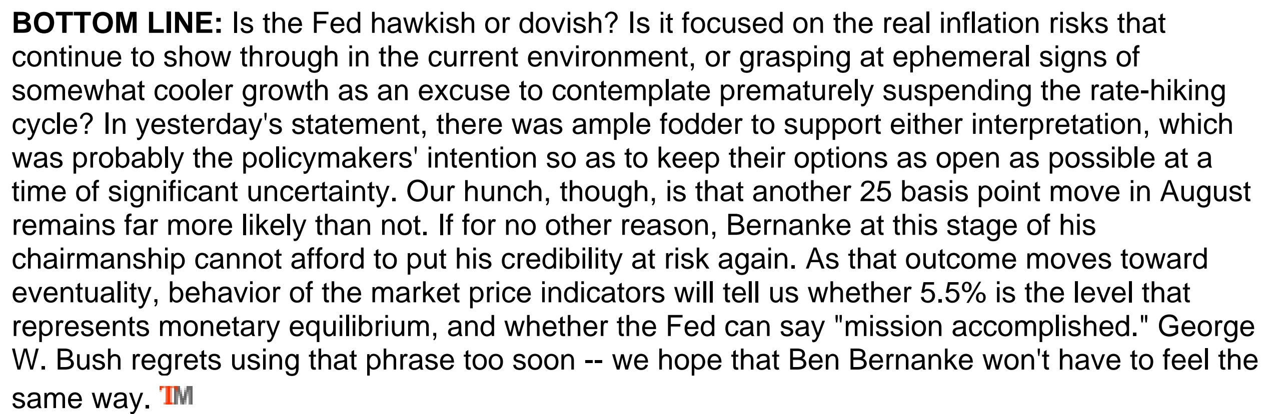
In what the market seems to have understood as a notable reflection of a somewhat less hawkish outlook, the phrase in last month's statement that "further policy firming may yet be needed to address inflation risks" was omitted. In its place, however, was an intriguing formulation: "The extent and timing of any additional firming that may be needed to address these risks will depend on the evolution of the outlook for both inflation and economic growth, as implied by incoming information." We think the reference to the inflation "outlook" can be understood as a indicating the heightened role now being played by inflation expectations as a distinct factor in policy formulation. This gives us some degree of confidence that the Fed would be less likely to pause unless measures of inflation expectations -- such as commodities, the dollar and TIPS spreads -- are well behaved. Then again, we note that the Fed was compelled once again to repeat the hackneyed phrase that "inflation expectations remain contained," even after it went to some lengths to acknowledge in the minutes of the May meeting that even while

http://www.trendmacro.com
don@trendmacro.com
dgitlitz@trendmacro.com
tdemas@trendmacro.com

Offices:
Menlo Park CA
Parsippany NJ
Charlotte NC

Phone:
650 429 2112
973 335 5079
704 544 6900

using that language, panel members recognized that expectations were in fact rising. And while the market price indicators have backed off their highest levels since then, they continue to point to an elevated level of expected inflation relative to the quiescent inflation rates seen in recent years. The worst risk here is that this have-it-both-ways characterization of inflation expectations will itself provoke those expectations to heighten, and thus embed inflationary impulses more deeply in the economy. That would add to the eventual cost of dealing with the inflation problem that the Fed seems so loathe to frankly acknowledge.



BOTTOM LINE: Is the Fed hawkish or dovish? Is it focused on the real inflation risks that continue to show through in the current environment, or grasping at ephemeral signs of somewhat cooler growth as an excuse to contemplate prematurely suspending the rate-hiking cycle? In yesterday's statement, there was ample fodder to support either interpretation, which was probably the policymakers' intention so as to keep their options as open as possible at a time of significant uncertainty. Our hunch, though, is that another 25 basis point move in August remains far more likely than not. If for no other reason, Bernanke at this stage of his chairmanship cannot afford to put his credibility at risk again. As that outcome moves toward eventuality, behavior of the market price indicators will tell us whether 5.5% is the level that represents monetary equilibrium, and whether the Fed can say "mission accomplished." George W. Bush regrets using that phrase too soon -- we hope that Ben Bernanke won't have to feel the same way. TM