TrendMacrolytics

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FED SHADOW

March to Folly

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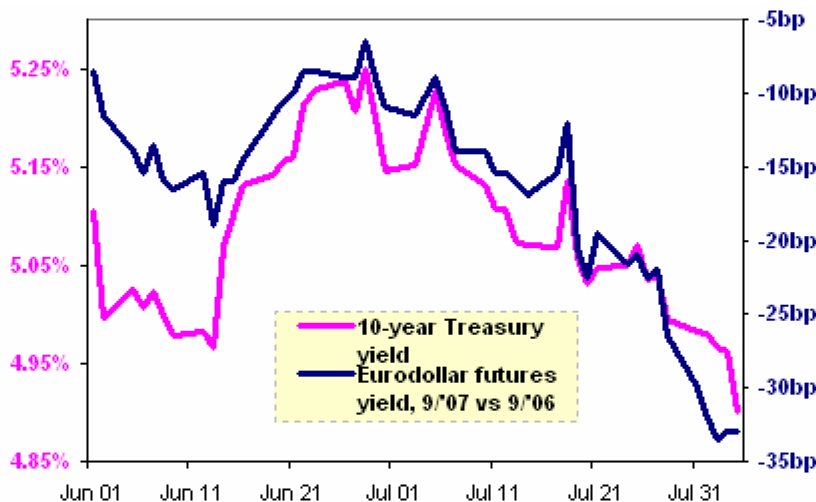
Today's job number seals the deal: the Fed is headed for a major error.

Update to strategic view

FED FUNDS: With this morning's weaker than expected jobs report, a Fed pause at 5.25% on August 8 is now nearly inevitable. A stronger than expected economy and continuing evidence of inflation will compel the Fed to resume its hiking regime, perhaps as soon as the September 20 meeting.

[see Investment Strategy Dashboard]

We must take it as a foregone conclusion that today's below-consensus gain in July payrolls will give the Fed the final excuse it needs to take a pass Tuesday on lifting the funds rate for the 18th consecutive FOMC meeting. After the initial estimate on second quarter GDP growth last week came in below expectations at 2.5%, it probably would have taken a job growth surge approaching 200,000 to keep the Fed on track (see "Data Dependent" July 27, 2006). However, we would caution against joining in any celebration based on the notion that next week's meeting will confirm that the Fed is done. While the central bank might well give apparent support to those yearning for a declared end to this policy cycle, any pause will likely be short-lived. The Fed's policy stance remains below equilibrium, as indicated by the response of gold, broader commodity indexes and the dollar's foreign exchange value this week as the consensus in favor of a pause has coalesced. Any slippage now from completing the task at hand will only put the Fed further behind the curve, requiring even more action later to catch up.



Indeed, the prospect of a Fed pause now represents the greatest risk yet to the sustainability of this expansion. The Fed is taking solace from its highly flawed demand-based models which tell it that growth is slowing sharply and that this will ease inflationary influences before long. The bond market is taking the Fed at its word, as the decline in the 10-year benchmark yield to below 5% since June has almost perfectly tracked expectations in the Eurodollar futures market for a rate cut by next fall (see chart). Moreover, bonds are pricing an inflation premium implying expectations of a falling inflation rate.

But we see nothing to suggest that the price pressures which have begun surfacing in the official data -- as a consequence of the long stretch of highly accommodative policy -- will soon

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run their course, whether or not growth slows. The Fed's favored inflation index, the core PCE deflator, is now running at its highest year-on-year rate -- 2.4% -- in 11 years. As recently as February, the year-on-year rate was 2%. The three-month annualized rate is 2.8%, up from 1.8% last February. This acceleration is likely to continue for the foreseeable future, and we could well see a three handle on the core PCE by year end. Without sufficient action to drain the excess liquidity long visible in market prices, the price indexes will continue to ratchet higher. Before very long, the Fed will run out of rationalizations to stand pat, and at that point would have little choice but to take a considerably more aggressive approach than has been seen thus far.

The Fed seems to have persuaded itself that it is facing only a fleeting uptick in core inflation as a consequence of the pass-through of higher energy prices. Apparently, there is not the slightest awareness at the Fed that such a pass-through is in itself evidence of an accommodative policy posture, nor that the rise in energy prices was in the first place rooted in the same monetary excesses seen in the rally in gold and the dollar's forex decline. The impression is growing that this Fed conceives of inflation as an exogenous factor for which it has no accountability or responsibility. This also implies a higher risk of significant policy error as it inclines policymakers to resist taking forceful enough action to correct their mistakes soon enough to keep them from doing significant damage.

BOTTOM LINE: With the outcome of Tuesday's FOMC session pretty well determined by today's payroll number, the significance of the post-meeting statement conveying the policy outlook takes on all the more importance. While we would not expect the panel to deliver an explicit "all clear" message, it's probably a good bet that the recent formulation that a cooling in growth should "limit inflation pressures" will be maintained. With it coming at the same time that the Fed is taking a pass on another rate hike, we'd view that as further confirmation of the problematic course of policy which will ultimately compel a tightening to truly expansion-threatening levels to root out the Fed's long-standing inflationary error. TM