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Both Sides Now

Wednesday, March 28, 2007

David Gitlitz

Bernanke makes it crystal clear there are risks to both growth and inflation -- leaving inflation "predominant."

Fed chief Ben Bernanke today rendered moot the instant analysis offered last week upon release of the FOMC statement asserting that the Fed was adopting a neutral posture, leaving it no more likely to raise rates than to cut them (see "Huh?" March 22, 2007). In response to questioning from Rep. Jim Saxton at a hearing of the Joint Economic Committee, Bernanke emphasized that despite removal from the statement of specific language positing the option of "additional firming," policy had "not shifted away from an inflation bias."

Still, while Bernanke's clarification on that score was somewhat reassuring to us, and confirmed our own analysis that the market's initial take was a misread (see "On Second Thought…" March 23, 2007), his testimony maintained an element of ambiguity that could continue to foster doubt about the Fed's commitment to rooting out lingering inflationary influences. Policymakers regard inflation as the predominant risk, Bernanke said, but at the same time other economic uncertainties have risen and it was felt therefore that "a little more flexibility might be desirable." Citing the continued correction in the housing market as well as some softness in business investment, as against recent "elevated" readings on core inflation, he suggested that "risks have increased on both sides" -- inflation and growth.

Bernanke's marginally hawkish-leaning comments were enough to spark a reversal of what had been a quarter-point gain in the bond market, with the 10-year Treasury down about seven ticks, yielding 4.63% in midafternoon trading. The selloff, however, was less marked at the short end of the curve and in interest rate futures, which remain nearly fully priced for 50 bps in rate cuts this year. Gold came off its highs for the day and the dollar firmed up modestly, but at $665 gold is nearly $10 higher than its levels prior to the FOMC release last week and the dollar's trade-weighted foreign exchange value is approaching two-year lows.

Update to strategic view

US BONDS: Bernanke's response to questions today, following his congressional testimony, further undermine the bond market's exaggerated hopes that the Fed is leaning toward concerns about economic growth in preference to its avowed "predominant" concern with inflation. With Treasury yields already well off their lows two weeks ago, we expect yields to edge higher as inflation risk mounts and threats to growth recede.

[see Investment Strategy Dashboard]c

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While it's debatable how much market price indicators register with Bernanke and the Fed, we know he closely follows the spread between nominal Treasuries and their CPI-indexed counterparts, TIPS, to get a read on shifts in the market's inflation expectations. Perhaps this is giving him some sense that the Fed's credentials as defenders of the purchasing power of the currency have not been bolstered by recent events. At about 249 bps, the TIPS spread has widened by some 9 bps from its pre-FOMC levels last week and is up nearly 25 bps from its lows early in the year. Should this trend be sustained to the point where the spread challenges last spring's highs around 275 bps, it could be an important component in compelling Bernanke & Company to face the reality that their mission to quell the inflationary impulses embedded by keeping policy too easy for too long remains incomplete.

BOTTOM LINE: Bernanke's response to questions today, following his congressional testimony, further undermine the bond market's exaggerated hopes that the Fed is leaning toward concerns about economic growth in preference to its avowed "predominant" concern with inflation. With Treasury yields already well off their lows two weeks ago, we expect yields to edge higher as inflation risk mounts and threats to growth recede.