TrendMacro

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FED SHADOW

It's Not Just a River in Egypt

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For the Fed, it's "jobs, jobs, jobs" -- and inflation is a matter of deep denial.

We had an extensive conversation with a voting FOMC member this week that confirms our view that, at this point, the Fed's bias is clearly to remain in rate cutting mode for at least one more FOMC meeting (see "The Fed Gets the Yips" September 19, 2007). We think our contact can be considered representative of the Fed consensus, as we have found in our discussions with him over the years that his views generally correspond with the middle-ground perspective of the FOMC.

Update to strategic view

FED FUNDS: The Fed is deeply entrenched in fears of a slowdown that will weaken the labor market, and thinks it has the scope to risk an increase in inflation to insure against that happening. Absent compelling growth data, we expect another 25 bp rate cut in October.

[see Investment Strategy Dashboard]

We could characterize the conversation by summing it up in one word: *denial*. He denies that the response of indicators such as the dollar, commodities and the yield curve to the Fed's 50 bp rate cut last week have any meaning with regard to the inflation outlook. The trend toward dollar weakness in foreign exchange is simply a matter of differentials between the funds rate and competing central bank rates, he said, despite conceding that the academic research finds no reliable correlation between variations in such differentials and exchange rate movements. The steepening of the 2/10 Treasury yield curve -- now at better than two-year highs of more than 60 bps, up about 40 bps since early last month, and more than 20 bps just since the Fed's cut last week -- also has no relevance for inflation risk, he insists. At the long end, yields are up due to the unwinding of safe haven flows into Treasuries. And in short maturities, the expectations of further Fed easing have kept yields from rising. Just like that, the rising risk premium in long-term versus short-term issues -- a classic inflation signal -- can be satisfactorily explained away. At the same time, he maintains that commodities such as gold are "fringe" markets with little meaning for the future price level.

For our purposes, we'd readily acknowledge that in isolation short-run movements in any of these indicators can be explained by non-monetary factors that would have no relevance for future inflation. However, when they are all lined up telling a consistent story with the dollar down more than 2% on a trade-weighted basis, gold now up about 3.5%, and the yield curve steepening just since the rate cut last week, the message is unmistakable: the purchasing power of the unit of account is eroding as a consequence of Fed policy (see "Honey, I Shrunk The Dollar" September 28, 2007).

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Although we are under no illusions that the Fed puts great store in these market price indicators in executing policy under its demand-based output gap models, it was striking nevertheless the degree to which this policymaker seemed intent on dismissing the signals of real dollar weakness. For the most part, Fed officials will maintain that while they do not treat these indicators as primary policy guideposts, neither do they entirely ignore them. The dollar's declining forex trend, for example, has been mentioned as a risk factor in recent FOMC minutes.

But it was clear that this policymaker believes that the primary current policy objective is guarding against a potential economic downturn, and perceives a benign inflation backdrop as providing the room needed to give the Fed the flexibility to act. He conceded that the Fed is now engaged in a risk management exercise under which it is willing to incur some increased risk of higher inflation in order to act against what it considers more severe downside economic risk. Inflation expectations are so well contained, he insists, there's little risk that inflation will actually end up rising as result.

It should be noted that the Fed went through a similar exercise earlier this decade when it was consumed by its deflation risk distraction, believing that lingering economic "slack" gave it the leeway to maintain an aggressive easing posture without incurring an inflation blowback, ultimately bringing the funds rate down to 1% in mid-2003. In the event, inflation subsequently accelerated, with core CPI rising to 2.9% last year from about 1% in late 2003, just as the market price indicators foresaw. Those indicators denote that the Fed maintained an accommodative posture even as it subsequently lifted rates to 5.25% by last year. The dollar continued to weaken on net and commodity prices continued to rise, as gold plateaued in a range around $650, some $250 above its highest levels during the 2002-2003 hyper-easing cycle. The statistical indexes have since fallen back, with core CPI now just slightly above 2% year-on-year, a development widely seen as corroborating that the inflation cycle has played out. Such mid-cycle pauses in statistical inflation are not unusual, however. During the inflation run-up of the late 1980s, for example, a similar period of moderation in the inflation indexes eventually ran its course and reported inflation went to new highs.

In the meantime, gold has rallied to nearly $750 and the dollar touched new all-time lows on a trade-weighted basis as the market prices the reality of an easy money response to the recent financial market turbulence by a cast of policymakers for whom the lessons of the past appear to hold little meaning. Indeed, in our discussion with this policymaker, it was clear that containing the potential labor market fallout of the credit market upheaval was an overriding goal. It was all too analogous to the early 1970s, when then Fed chairman Arthur Burns as much as declared that acting to forestall short-term increases in unemployment took precedence over securing long-term price stability.

BOTTOM LINE: For all the apparent fixation of the Fed on forestalling an economic slump as fallout from the recent financial market turmoil, the fact remains that there is scant evidence to suggest any significant slowing is underway. For a central bank whose focus on the labor market is nearly obsessive, last month's report of a decline of 4,000 payroll jobs was surely pivotal in the subsequent decision to cut rates by 50 basis points. But the notion of a serious weakening in the jobs picture is belied by weekly jobless claims, which have declined in each of the past four weeks and, now at less than 300,000, are indicative of a continued robust labor market. Today's report of a 0.6% jump in personal consumption last month also betrays no hint of weakness. At some point, the Fed will be swayed by this evidence and call off its ill-conceived return to easing mode. At this moment it seems unlikely that such evidence will come soon enough to keep policy from entrenching the already apparent inflationary impulses even more deeply.