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High Anxiety

Thursday, January 3, 2008

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The Fed is worried -- but only about credit markets, not inflation.

The Fed may have hoped that raising the possibility of a potential "substantial further easing of policy" would provide assurance that it would do what's necessary to keep credit market unrest from infecting the broader economy. But the troubled tone of the December 11 FOMC minutes released yesterday served mainly to deepen anxiety about the economy while reinforcing the growing impression that the Fed's price stability objectives are decidedly taking a back seat as it endeavors to attend to the volatile market environment. At this point, the Fed is acting as though it is blind to the mounting risk that its monetary activism will eventually beget a sharp inflation breakout that would eventually bring about the worst possible outcome for the economy and the markets.

Update to strategic view

FED FUNDS, US BONDS: Futures markets now are priced not only for another fed funds rate cut to 4% at the January FOMC meeting, but further reductions to bring the rate down to 3% by later this year. Up to now in the credit market turmoil, the Fed has been fearful of disappointing fragile markets. That's unlikely to change this month, but at some point, the Fed will be compelled to face the reality of an increasingly less benign inflation situation, which will leave fixed income markets highly exposed, as they have priced for Fed nirvana for as far as the eye can see.

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The Fed's degradation of the dollar can be seen mostly clearly in the continued upward trek of the price of gold. Yesterday it broke through its previous all-time high of $850 seen during the inflation maelstrom of 1980 and, and now in a range around $860, it's trading some $200, or30%, above levels since the August market disruptions sharply upped the odds that the Fed would be compelled to engineer a monetary bailout. But while gold is the most sensitive of monetary indicators, it is hardly alone -- forex, crude oil and a broad range of commodities are all carrying the message that an excessively easy Fed is ever more deeply embedding inflationary influences into the system. Even the bond market, where long-term yields currently below 4% are failing to provide a positive after-tax real rate of return, is showing some recognition of rising inflation risk, with the 10/2 yield curve now above 100 bp. In early August, the spread was less than 20 bp.

For this Fed, though, the inflation outlook revealed in the minutes can only be described as complacent compared to its worries over potential credit market fallout. "Members judged that the softening in the outlook for economic growth warranted an easing of the stance of policy at this meeting," the minutes said. "Downside risks to the expansion, resulting particularly from the weakening of the housing sector and the deterioration in credit market conditions, had risen," according to the policy record. It then broached the risk of "an unfavorable feedback loop in which credit market conditions restrained economic growth further; leading to additional tightening of credit; such an adverse development could require a substantial further easing of policy."

As for inflation, while noting the increases in energy and food prices and the rising price of imports resulting from a weak dollar, the Fed appears largely unruffled -- -- especially compared to the more hawkish tone taken in mid-November (see "Gold's New Line in the Sand" November 20, 2007). "With futures prices pointing to a gradual decline in oil prices and with an anticipation of some easing of pressure on resource utilization, participants generally continued to see core PCE inflation as likely to trend down over the next few years." The December meeting took place prior to release of data showing an unexpected uptick in several inflation indexes. However, there has been little sign from within the Fed that the latest readings have meaningfully changed its perspective on the inflation outlook.

The latest ISM manufacturing survey, showing a drop in the index to contractionary levels, likely will feed into the Fed's inclination to remain in rate-cutting mode at least though the FOMC meeting late this month. At 47.7, the ISM purchasing managers index is at its lowest levels since early 2003, and a continued run at these levels would be a troubling sign for the overall economy. But it would be premature to make a judgment on the basis of one month alone. There have been any number of occasions when the index has slipped below the break-even 50 line only to rebound the following month, including last January. In addition, according to the ISM, at these levels -- or any above 41.9 -- the index is consistent with continued growth in the overall economy.

BOTTOM LINE: Futures markets now are priced not only for another Fed funds rate cut to 4% at the January FOMC meeting, but further reductions to bring the rate down to 3% by later this year. Up to now in the credit market turmoil, the Fed has acquiesced to these expectations, apparently fearful of disappointing fragile markets. That's unlikely to change for this month. But at some point, we see the Fed being compelled to face the reality of an increasingly less benign inflation situation, which will leave fixed income markets highly exposed, as they have priced for Fed nirvana for as far as the eye can see.