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FED SHADOW

# Helicopter Ben Takes Flight

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**The more Bernanke gives, the more the markets want -- and the more money gets dropped.**

| **Update to strategic view** |
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| **US BONDS:** The steepening of the 10/2 curve to 3-year highs following Ben Bernanke's dovish speech yesterday indicates that the bond market is beginning to sniff out the makings of an inflation breakout. In the longer run, that means Treasury yields cannot be sustained at today's low levels. |
| [see Investment Strategy Dashboard] |

One of the more curious things about Ben Bernanke's maximally dovish speech yesterday was that his assurances about being prepared to take further aggressive easing action were preceded by an acknowledgement that inflation was becoming more problematic. "The same increase in oil prices that may be a negative influence on growth is also lifting overall consumer prices and probably putting some upward pressure on core inflation measures as well," he said. "Any tendency of inflation expectations to become unmoored or for the Fed's inflation-fighting credibility to be eroded could greatly complicate the task of sustaining price stability."

But in the next breath, the Fed chief was in full capitulation mode. "Additional policy easing may well be necessary," he said, as the Fed stands "ready to take substantive additional action… to provide insurance against downside risk," and is "prepared to act in a decisive and timely manner." With the juxtaposition of these two formulations -- recognizing increased inflation risk on the one hand while at the same time essentially pledging to take significant additional easing action -- Bernanke is as much as admitting that securing the purchasing power of the dollar has been relegated to low priority in the Fed's scheme of things.

At the least, Bernanke's speech virtually ensures that the 50 bp cut to 3.75% in the funds rate target now fully priced in the futures markets will be sanctioned by the FOMC on January 30. Whether the Fed will stay on course to meet the anticipated path of rates reflected in the futures -- which would put the target at 3% by June -- remains to be seen. For now, though, it's clear that this central bank is loath to risk disappointing those expectations.

The pressures bearing down on Bernanke from the Wall Street crowd to satisfy those expectations have become none too subtle. A front page story in the business section of yesterday's *New York Times* questioned whether Bernanke is "tough enough," citing "many on Wall Street" who argue that he "should be dealing with the situation more aggressively than he has so far." In a bizarre warping of institutional history, the article says these financial market notables "complain" that Bernanke "appears to be reluctant to strong-arm his colleagues" the way his predecessors, including Paul Volcker, often did. Volcker, of course, was presiding

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during the worst episode of inflation since the Civil War, and was "strong arming" people to keep them on board during an extremely painful tightening process. But according to the *Times* and its sources, this is somehow analogous to the current cycle, where the only open question is how much easier the Fed should get. Not until the end of the story is it acknowledged that more than a little self-interest may be motivating those lobbying for an aggressive course of rate cuts. "Wall Street traders and investment bankers are counting on drastic rate cuts to help make stock prices rise" and, in the process, lift their bonuses. Quoting a hedge fund consultant, the piece concludes, "It is easier for people on Wall Street to cloak their personal desires in a national concern."

But the problem for Bernanke is that the more he gives in to this pressure, the more the market expects and, essentially, demands (see "'Act As Expected'" November 28, 2007). Prior to the speech yesterday, fed funds futures were showing an 80% chance of a 50 bp cut at the meeting later this month. Today, they're pricing a 32% chance of the rate being cut by 75 bp, to 3.5%. If those probabilities continue to rise, showing a better than even chance of that outcome by the time of the meeting, we wouldn't bet against it.

For all the economic angst currently infecting the markets which underpinned Bernanke's remarks yesterday, the source of it remains difficult to pin down. In asserting that "downside risks to growth have become more pronounced," he first cited further weakening in housing demand as "likely to weigh on consumer spending." However, during the entire housing downturn, now going on two years, there has been absolutely no associated penalty on consumption. While the fourth quarter showed signs of significant slowing from the blistering 4.9% pace of growth in the third quarter, personal consumption spending is slated to come in at about a 3% growth rate. Another "consequential risk to growth," he said, is the labor market, noting the 0.3% increase in the unemployment rate to 5% in the December jobs data released last week. That jump, however, was based on a decline of more than 400,000 jobs in the household survey, which has been extremely volatile over the past several months. In November, household jobs grew by more than 600,000, and by about 500,000 in September. The December decline in jobs could well be reversed in the next employment report, and along with it the rise in the unemployment rate. At the same time, jobless claims in the most recent week fell back by 15,000 to 322,000, a level that does not suggest a retrenchment in the labor market is at hand.

Bernanke's willingness to look past current inflation risks in pointing toward further rate cuts is based at least in part on the hoary Keynesian notion that slower growth will mean reduced inflation pressure. In his speech yesterday, he appeared to take comfort that "pressures on resource utilization have diminished a bit." This appears to be a particularly inapt formulation at this point, however. Not only are the sensitive market prices which we watch most closely showing signs of intensifying inflationary impulses -- with gold now at record highs above $890 -- broad commodity indexes are showing absolutely no inkling of downside price pressures that would arise from falling demand. The CRB Spot Index -- which does not include gold or petroleum -- is now at new all-time highs.

**BOTTOM LINE:** Another hit to equities today is spurring a renewed flight to quality in Treasuries, pulling the 10-year yield lower by about 7 basis points to 3.82%. But the bond market's response to Bernanke's speech yesterday was instructive, as long maturities sold off by nearly a point even as the short end rallied. The result was a 9 bp steepening in the 10/2 curve. That steepening has continued today, with the curve now at more than 120 bp for the first time in more than three years. While yields for now remain at extraordinarily low levels, this steepening tells us that the bond market is beginning to sniff out the makings of an inflation breakout which, in the longer run, certainly does not bode well for any hope that yields can be sustained at these levels.