Trend Macrolytics, LLC
Donald Luskin, Chief Investment Officer
David Gitlitz, Chief Economist
Thomas Demas, Managing Director

FED SHADOW

"No Quandary Here"?

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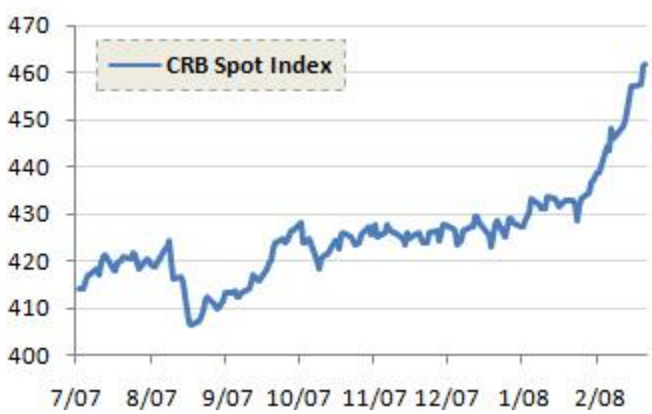
David Gitlitz

The Fed has a bogus rationale for sacrificing price stability on the altar of easy money.

Update to strategic view
US MACRO: The Fed is rationalizing away the inflationary consequences of its extreme easy money approach to the credit crisis and the slowing economy. Even if growth slows substantially, that won't ease inflation pressures as the Fed claims. When it's all over, the Fed will have a costly inflationary mess to clean up.
[see Investment Strategy Dashboard]

Following yesterday's upside surprise on the January Consumer Price Index, the press today is brimming with stories about the possibility of stagflation. One implication is that the combination of an economic slowdown and rising inflation presents a real quandary for the Fed as it endeavors to get rates low enough to appease the market and keep the economy afloat. But the Fed makes it sound as though there were no quandary at all. The minutes of the January 30 FOMC meeting released yesterday make clear that while the Fed acknowledges -- and even projects -- the likelihood of somewhat higher inflation in the short run, it is confident that a slowing economy will take care of any upward inflation pressure. At the same time, it continues to perceive still formidable "downside risks" to the economy, and is prepared to "act in a timely manner as needed to address those risks." It has become increasingly apparent that price stability is currently relegated to a distinctly secondary spot on the Fed's roster of priorities.

The reported above-expectations jump of 0.3% in core CPI was the highest one-month change in more than five years. Obviously, one month does not make a trend, but the trend has already been moving higher, with the year-on-year core rate now at 2.5%, up from 2.1% just last August. While much of this bump up in the deeply lagging statistical indexes is attributable to the Fed's policy stance even *before* the most recent run of easy money beginning last September, more time-sensitive recent data capture the additional inflationary impulses now being embedded into the system. Reflecting the dollar depreciation induced by the Fed's surplus liquidity policy stance, non-petroleum import prices in January were up at a 12-month rate



http://www.trendmacro.com
don@trendmacro.com
dgitlitz@trendmacro.com
tdemas@trendmacro.com

Offices:
Menlo Park CA
Parsippany NJ
Charlotte NC

Phone:
650 429 2112
973 335 5079
704 552 3625

of 3.6%, versus 1.5% a year ago; on a three-month annualized basis, the rate is soaring by 6.5%.

The most recent intensification of the Fed's easing campaign -- having cut rates by 125 basis points within the space of eight days last month -- is deepening these inflationary influences considerably. Gold today is at new record highs above $950, more than 10% above the price seen prior to the Fed's intermeeting cut last month on January 22. The CRB spot commodity index provides perhaps the most compelling illustration of the impact of these moves, as can be seen in the chart on the previous page. The index was already running at near-record highs prior to the first January cut. The steepening of its upward trajectory since then is striking.

There are also indicators to which the Fed itself professes some fidelity which are now sending signals which the Fed probably views as distinctly inconvenient right now. The 5-year forward TIPS spread, which Fed chief Ben Bernanke has cited as an expectations gauge that he monitors, is now at 2.74%, up about 30 bps in the past month. In the minutes yesterday, the Fed noted that "longer-term financial market gauges of inflation compensation had climbed," but averred that this "probably reflected at least in part increased uncertainty -- inflation risk -- rather than greater inflation expectations." In supporting this rationalization, the Fed suggests that "increases in nominal wages did not appear to be incorporating higher inflation expectations." The empirical record, however, is clear that wages are a lagged response to rising inflation, not a contemporaneous expectations indicator.

This wage-based view is an application of the same fundamentally flawed logic by which the central bank is able to insist that "the slow growth in economic activity anticipated for the first half of this year and the associated slack in resource utilization would contribute to an easing of price pressures." Among the cathedrals of the economic establishment -- of which the Fed can be viewed as akin to the Vatican -- this demand-based paradigm remains impervious to repeated episodes which demonstrate the fallacy of the proposition that inflation is a growth phenomenon. In the most clear cut examples, in the1970s and early '80s -- the stagflation era -- inflation soared as growth fell. And in the late 1990s, inflation fell as growth accelerated. Over the years, it's impossible to detect a stable relationship between growth and inflation, because there isn't one.

BOTTOM LINE: The Fed continues to dig itself deeper into its inflationary pit. In the FOMC minutes released yesterday, the central bank acknowledged that inflation was running somewhat higher than it would prefer, but hardly seemed troubled by it, content to stick by the shopworn notion that slower growth will bring down price pressures. While we don't doubt that senior Fed officials sincerely believe that, it's also probably the case that they see themselves as having no choice at present but to continue on this easy money track, and will deal with any inflation consequences when the time comes. For our part, we view this as a highly shortsighted policy approach, which likely will ultimately bring about the kind of deleterious economic consequences that the Fed is now making such concerted efforts to avoid.