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FED SHADOW

The Fed, Blinded by the Obvious

Thursday, April 30, 2009

David Gitlitz

Of course the economy has improved slightly -- but the Fed remains bent on inflation.

While the FOMC yesterday acknowledged the obvious, noting that the "economic outlook has improved modestly," nothing in the policy statement should be construed as indicating that the Fed is prepared to shift away from its exceptionally easy policy posture in the foreseeable future.

Bond yields jumped, with the 10-year Treasury piercing 3.10% for the first time this year, and gold sold off. But we don't think any bet tied to the notion of a change in course for the Fed is likely to be sustained. First, the central bank is clearly prepared to continue anchoring the yield curve with the funds rate set essentially at zero, declaring that "economic conditions are likely to warrant exceptionally low levels of the federal funds rate for an extended period" -- eerily reminiscent of the "considerable period" the Fed promised in late 2003. That commitment is likely to limit the upside in bond yields, as it did then.

The Fed also signaled its commitment to press ahead with the array of liquidity facilities and securities purchase programs, including the $300 billion acquisition of long-term Treasuries, noting its objective is "to provide support to mortgage lending and housing markets and improve overall conditions in private credit markets." While it gave no indication that it currently anticipates expansion of the programs, which might have contributed to the denting Treasuries took yesterday, we see that as having been left an open question. "The Committee will continue to evaluate the timing and overall amounts of its purchases of securities in light of the evolving economic outlook and conditions in financial markets." That could be interpreted as suggesting the Fed is neutral as to whether going forward the purchases could increase or decline, but it seems a safe bet at this point that its first priority is to see yields kept in check. If at some point that requires an increase in Treasury purchases, that's what will be done.

Update to strategic view

US BONDS: With the FOMC acknowledging that economic conditions are getting less bad, long Treasury yields are testing the Fed's implicit promise to intervene to suppress them. We don't know what the limit is, but we think the Fed's promise is real, and that it remains too early to sell short.

GOLD: Gold remains in a high-level consolidation, while the market decides whether to believe the Fed's deflation story, or the inflation story already beginning to play out in official price indexes. We believe the latter, and expect gold to work to all-time highs.

[see Investment Strategy Dashboard]

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The Fed is convinced it has a free hand to continue injecting liquidity without limit because in its typically Keynesian fashion, it believes that in "light of increasing economic slack here and abroad, the Committee expects that inflation will remain subdued." At the same time, the Fed is being egged on by a political environment that has adopted a "do whatever it takes" approach to economic recovery. In this climate, the hard-earned commitment of the Volcker/Greenspan years to the idea that central banks cannot inflate an economy into full employment seems to have been thrown out the window. Instead, we see even sensible economists like Greg Mankiw, chair of the Council of Economic advisors under President Bush, publicly suggesting that the Fed "embrace inflation" by adopting a negative interest rate target. In such an environment, the Fed surely lacks the political will to tighten policy as inflation continues to edge higher. And with Ben Bernanke's term as chairman up early next year, if he *does* summon the will, he'll likely be replaced by someone like Larry Summers who won't.

So now, when the FOMC speaks of "price stability," it is referring to deflation, not inflation. In yesterday's statement, the FOMC said it sees "some risk that inflation could persist for a time below rates that best foster economic growth and price stability in the longer term." In other words, the Fed remains on deflation alert despite the range of indicators showing that the deflationary influences that were in play during the worst of the market panic late last year have been overcome. Gold is up more than $200 from its October lows, while a variety of broader commodity indexes are up considerably. Even the deeply lagging official price indexes are beginning to tick higher. Personal Consumption Expenditures inflation is rising at a 2.2% 3-month annual rate, and core PCE inflation is even higher at 2.3%. With risk aversion still in a heightened state, we don't dispute that money demand remains elevated. But a central bank battling non-existent deflationary forces is setting the stage for a significant inflation breakout down the road once conditions normalize and policy is too slow to respond. That still gives us considerable confidence that the high for gold above $1000 will yet be seen. Eventually, it will be very bearish for Treasuries. But that day of reckoning is still a ways off, as mounting inflationary impulses remain obscured by lingering deflation fears, and the specter of further Fed interventions suppresses yields.

BOTTOM LINE: The Fed offered a somewhat upbeat assessment of the economic outlook yesterday, but it shows no sign of considering a near-term shift in its policy posture. The Fed's conception that it is currently running no inflation risk is deeply flawed, but it will yet be some months before that becomes clear. With the FOMC acknowledging that economic conditions are getting less bad, long Treasury yields are testing the Fed's implicit promise to intervene to suppress them. We don't know what the limit is, but we think the Fed's promise is real, and that it remains too early to sell short. Gold remains in a high-level consolidation, while the market decides whether to believe the Fed's deflation story, or the inflation story already beginning to play out in official price indexes. We believe the latter, and expect gold to work to all-time highs.