ECOMENTARY™

MAS 050305

Coulda, woulda, shoulda: will the Fed come to regret its bet?

The FOMC raised its target Federal Funds rate by 25 basis points to 3 per cent, and it implicitly focused on what kind of inflation the economy is likely to experience going forward. It is what the Statement did not say that has to concern the market. Ironically, in the first release, the italicized sentence in the second paragraph was omitted. We started to write our commentary noting this omission and fortunately waited (for other reasons) to publish our thoughts on the statement. A new release of statement put the key sentence back in again, but it does not entirely resolve our doubts.

> The Federal Open Market Committee decided today to raise its target for the federal funds rate by 25 basis points to 3 percent.
>
> The Committee believes that, even after this action, the stance of monetary policy remains accommodative and, coupled with robust underlying growth in productivity, is providing ongoing support to economic activity. Recent data suggest that the solid pace of spending growth has slowed somewhat, partly in response to the earlier increases in energy prices. Labor market conditions, however, apparently continue to improve gradually. Pressures on inflation have picked up in recent months and pricing power is more evident. **Longer-term inflation expectations remain well contained. (their emphasis)**
>
> The Committee perceives that, with appropriate monetary policy action, the upside and downside risks to the attainment of both sustainable growth and price stability should be kept roughly equal. With underlying inflation expected to be contained, the Committee believes that policy accommodation can be removed at a pace that is likely to be measured. Nonetheless, the Committee will respond to changes in economic prospects as needed to fulfill its obligation to maintain price stability.

When one compares the May 3rd and March 22nd statement, one has to note that the Committee chose to shift from "output evidently continues to grow at a solid pace despite the rise in energy prices," to the May 3rd view, wherein "recent data suggest that the solid pace of spending growth has slowed somewhat, partly in response to the earlier increases in energy prices. (emphasis added) The distinctions here are two-fold.

First output growth continuation (earlier statement) as compared to 'spending growth" (current statement) has slowed. We take it that the FOMC wanted to alert us to a change in conditions: Fast to Slow---but they peculiarly chose to change the economic metric, from output to spending. This is a distinction without a difference from a policy point of view, even if it is the one drawn sharply by Ted Truman in a recent **FT** Op-Ed. There can be a distinction between spending and output if one is trying to drag through the door the issue of the U.S. import surplus. But is that what the FOMC wants us to concentrate upon? We doubt it. Second, if in fact the economy is operating at 'less than full employment," then a slowing of demand growth will cut output sooner or later. What the Fed is trying to do is to dance between the two metrics to tell us inflation is likely to be less of a problem going forward and therefore "balance" is achievable even with a measured pace of increase for the Fed Funds rate. This is just short of a word game that can be easily destroyed by unforeseen inflation. This kind of reassurance---one built upon a forecast not seen---cannot quiet market doubts.

Perhaps more importantly, one ought to consider what is implicit in the FOMC statement today, namely that the driver for price pressure seems to be energy prices. That is also a dangerous tack for the Fed. They will not be better at predicting energy prices than anyone else in the market although, at present, they seem to be taking comfort that the last few days (since the peak of April 22nd) has sent some messages of future relief

ECOMENTARY? is published for clients of **Munk Advisory Services, LLC**
P.O. Box 749, Horsham, PA 19044
Reproduction or quotation by permission only.
Website www.ecomentary.com. Contact: munkb@ecomentary.com

through lower spot crude prices. But 'oil is a greasy business,' as Calouste Gulbenkian once remarked, and the Fed is stepping out into a very dicey arena to base its balance of risk statement on an oil price forecast. Abandon hope, all ye who enter here, the poet once said.

In light of the error made by former Chairman Arthur Burns in not responding quickly enough to rising energy (and other) prices, hopefully this Fed is not about to relent in its pursuit of a more solidly grounded (and higher) real federal funds rate. If in fact energy prices once again start rising, this statement is going to be used against the Fed and the emboldened sentence first left out in paragraph two ("longer term inflation expectations remain well contained.")

A wing and a prayer philosophy which tells markets that the Fed doesn't have to do more right now since it does not sense a rise in expectations of inflation has to be backed by some solid evidence and well thought-through theory. So far, we have not seen it. What if, for a wide variety of reasons, prices do start rising, and perhaps at a sharper rate? Does that mean that the market will have to get solidly whacked from a newly, unmeasured Fed?

The Chairman has already alluded to the 'conundrum' of lower mid term interest rates in spite of many increases in the Funds rate. Prospects of slower growth will add to that conundrum, as evidenced by the sharp fall in the 10-year treasury over the past few weeks as the chant of a Soft Patch increased.

If, in fact, price rises accelerate and some pick up in inflationary expectations becomes apparent, the FOMC is going to be thinking "could have, would have, should have' and wished it had raised more sharply now or alerted the market that it was giving that outcome some consideration! It's a helluva a bet for a Central Bank.

Admittedly, this is an age of big bets as evidenced by Warren Buffett's 320 Billion dollar bet against the dollar. That bet may also come true, because if the Fed does indeed fall behind the curve, the US dollar is going down ….big! Could have known, would have known, should have known. This Fed might have considered the wisdom of at least taking out some insurance…but this Fed is a gambler!