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Getting Behind the Curve: Real or Imagined Threats

With the most likely outcome of the FOMC's deliberations tomorrow a 25 basis point rise (the overly uniform consensus), economist jabber in the past few days has focused on whether the Fed is 'behind the curve.' The phrase itself is misleading, because the alleged curve behind which the Fed is sometimes accused of lurking involves two very different kinds of perceptual issues. One ought to distinguish between possible forecast errors of the Fed's predictions (e.g. core inflation, however measured) and possible model uncertainties that link the effects of a change in inflation to other economic variables. The first question to ask is: has the Fed

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1) FFM4	Jun04	98.980s	-.01%	Close	98.975	98.985	108816	137	98.985
2) FFN4	Jul04	98.730s	unch	Close	98.725	98.730	141095	2746	98.730
3) FFQ4	Aug04	98.495s	unch	Close	98.485		167622	7132	98.495
4) FFU4	Sep04	98.290s	+.01%	Close			59572	6219	98.280
5) FFV4	Oct04	98.100s	+.01%	Close	98.100	98.105	41595	3384	98.090
6) FFX4	Nov04	97.900s	+.02%	Close	97.900	97.920	45392	632	97.885
7) FFZ4	Dec04	97.715s	+.02%	Close	97.710	97.715	26866	783	97.695
8) FFF5	Jan05	97.620s	+.02%	Close	97.590	97.620	10720	25	97.605
9) FFG5	Feb05	97.380s	unch	Close	97.350		1122	0	97.380
10) FFH5	Mar05	97.200s	unch	Close			15	0	97.200
11) FFJ5	Apr05						0	0	
12) FFK5	May05						0	0	
13) FFM5	Jun05						0	0	
14) FFN5	Jul05						0	0	
15) FFQ5	Aug05						0	0	
16) FFU5	Sep05						0	0	
17) FFV5	Oct05						0	0	

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made a poor forecast? The second is how will the Fed adjust to its "error?" Only special cognoscenti could answer the error in forecasting issue, but the FEDSPEAK of the previous two weeks suggests that the prevailing (internal) Fed forecast for inflation did not include the outcomes actually encountered. The second issue, often latent, but no less important, is the "model" that the Fed is using to make its estimates of unexpected changes in a key variable, such as inflation. Only when one can 'suppose' the model that the Fed is using could one start down the path of a meaningful answers to the question, "Is the Fed behind the curve?" Furthermore, any judgment about where the Fed is as opposed to where a particular private analyst might be involves knowing the model of the evaluator as well.

We infer from comments of many analysts that the Fed's poor forecast condemns the Fed to be behind the curve. This is clearly an incorrect inference, particular as the Chairman has suggested several times that the Fed knows that it is ultimately responsible for the extent of inflation. Even if the past FOMC statement enshrined the word "measured" in our lexicon of FOMC responses, let core inflation rise significantly over more than a short period and the Fed will indeed take away the punch bowl

Where does that leave us?

While there is a 'central tendency' to a group of forecasts (say a group of analysts), the distribution of possible outcomes also counts in determining if policy is 'behind the curve.' Another important question to ask is which curve would that place the Fed behind? The market's forecast is one of future inflation (and implicitly

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equilibrium real interest rates) and it would imply that the Fed's model of the effects of inflation is different from that of the market.

What do we know as of this moment? Perhaps, most importantly it is that the current uptick in core inflation (however measured) has surprised the Fed. But, it is their forecast going forward that will count. The market is unlikely to know that forecast for sure. What the market can do, and probably has done, is to compare what **they think the Fed is forecasting**, and what the **market thinks** is a realistic inflationary forecast. For example, consider the following comment from our friend Brendan Brown at BTMI:

> In particular the present growth cycle upturn of the US economy has indeed been largely pump-primed by easy US monetary and fiscal policies. But that does not guarantee maturing into a self-sustaining long upturn. With US personal savings rates near a record low, the residential real estate market ripe for consolidation (at best), and the pace of technological change having slowed, how can the BIS authors be so sure of forward momentum? Add to that the global influence of the severe slowdown of the Chinese economy, of which today's disappointing news on Japanese industrial production may be the first evident spillover (see below).
>
> Very short-run indicators of the US economy suggest that a slight slackening of the pace of advance already has occurred in recent weeks (most recently sales disappointment at GM).
>
> In sum, the BIS commentators are concerned that if this economic expansion proves to be like that of the 1990s then indeed there will be a big job of fiscal and monetary tightening and valuable time might even have been lost already. But they do not show measured or equivalent concern for the possibility that this is a fundamentally low-momentum world economic upturn.

Three Coins in the Fountain: If you are not confused, you have not been following all the commentary proliferating through the market. There are data points on both sides of the monetary policy debate because the outlook going forward is truly hazy. In scenario terms, we could posit three distinct outcomes: **Classic Monetary Boom**: continuing boom with inflationary pressure requiring the Fed to act more harshly than is currently anticipated. **Goldilocks**-inflation has peaked and will drift lower going forward allowing the Fed to be quite **measured** as it moves through this year, but with higher possibilities of a fade meaning the return to an equilibrium real funds rate that would take all of 2005;**Stagflation déjà vu-** a return of stagflation during which the productivity induced growth spurt subsides, but some inflation will remain but without substantially greater employment growth. The last scenario nearly implies some strong imperfections of the labor market allowing it to have strong wage growth in the skilled sectors but poor growth at lower skill levels. That scenario is the most troublesome one for the Fed because a dual mandate in this scenario is really a recipe for political controversy. The Fed is hoping for the Goldilocks Scenario. That is the most probable outcome, but it is not a certainty. One way to read the Fed, if they leave the "measured doctrine" largely in play while stating the Central Bank Catechism on inflation, is that they do indeed have Goldilocks on their mind. In that case, one could infer that the Fed has a "three coins in a fountain" model working and is waiting further data to validate the probabilities of each occurring. Isn't that what a risk manager is supposed to be doing?

At the end of the day, despite the rhetoric of the "getting behind the curve," in the Bond Market, there is no single curve that the Fed is behind. The Fed can get blamed for nearly all possible outcomes. That is the benefit of hindsight when foresight is in short supply, which it invariably is.