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Fed Focus is on Inflation

The only real surprise in the FOMC statement today was the lack of unanimity. Board member Mark W. Olson took a stance uncommon during the Greenspan era. He said "no" apparently preferring a hold up on the Fed's strategy of removing accommodative monetary policy. We will have to wait for the minutes to be released or perhaps a future speech to fully understand his reasoning. The FOMC retained its measured "pace" doctrine, and the FOMC continued to address price stability with its usual caveat about being responsive "to changes in economic prospects"

The opening analytical paragraph focused on the aftermath of Hurricane Katrina suggesting that there will be impacts on energy prices, spending, production and employment and that the disruptions to the oil sector could add to energy price volatility. Recognizing the shock, however, did not imply that the FOMC saw a "persistent threat" to its assessment that "robust underlying growth of productivity" continues to provide ongoing support to economic activity." None of the repeated threats of "stagflation," now widely bandied about in the economic press, showed in this statement. The forthcoming Minutes may be more instructive, but with the FOMC failing to detect any recent upturn in longer-term inflation expectations, they are not willing to pause at this point and take a chance that such expectations could result were the market to doubt the FOMC's anti-inflationary commitment. This has been a key idea for us. We had always thought that if the Fed paused they would send a very uncertain signal to the market, as if to say by such hesitation, 'we see something out there that could be troubling!'

In our view, the Fed is not willing to tamper with its historical evaluation of mistakes in Fed policy made during prior oil shocks. Their commitment is a bulwark against the development of inflationary expectations.

As an aside, the "no" vote by a Board Member suggests that the end of the Greenspan era is coming closer and secondly, the FOMC is really the domain of professional economists. Judging by the TV commentary we have watched over the past two weeks, the only real resistance to another elevation in the Funds rate seemed to have come from those with roots in the financial services industry. As the Funds rate rises and (at least so far), little of that elevation at the short end of the curve has translated into an elevation at the long end. Consequently, the "carry trade" is weakened. We should expect and did observe complaints from practitioners of the trade.

It is true that very recently there has some "steepening." However, the steepening has been quite modest comparatively little, while risk and duration spreads are still quite compressed. While the Greenspan "conundrum" has weakened slightly, by and large, all of the FOMC's pressure has been transmitted to the shortest end of the curve. Not surprisingly, financial service participants become much more sensitized to the reduced spreads. At the same time, professional economists see that compression as a strong indicator of the degree of monetary ease. They can't both be right, can they?

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