THE ECONOMIC OUTLOOK GROUP

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ECONOMIC TALKING POINTS

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April 15, 2011

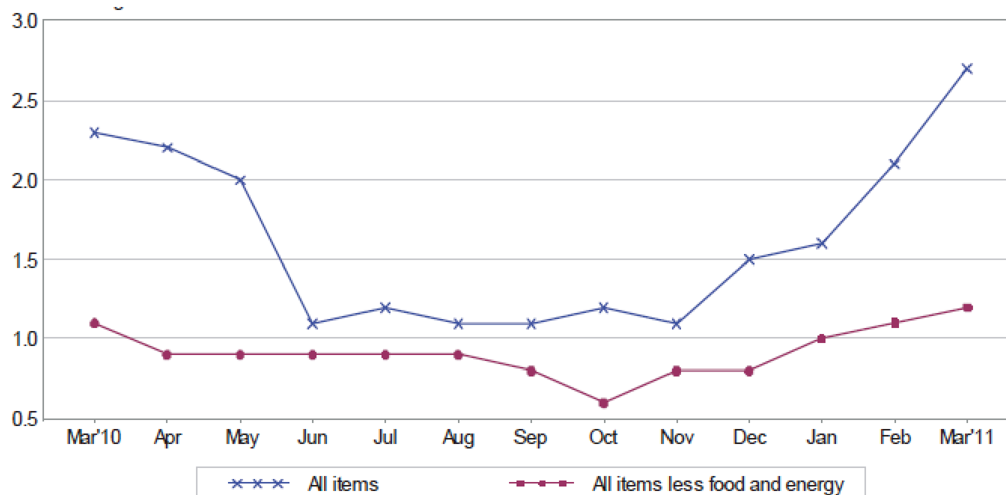
Inflation and Inflation Expectations Are On The Rise. Is the Fed Reacting Too Slowly?

Could the Federal Reserve be already behind the curve to keep inflation tame?

Not yet, but the time to tighten monetary policy is edging much closer. For now, the inflation warning lights are flashing yellow. However, with the CPI up 2.7% over the past 12 months, the most in more than a year, and with annual price increases accelerating each of the past four months, the warning lights are likely to turn red this summer. That means pressure will build on the Fed to act --- and act decisively --- before the year is out.

12-month percent change in CPI for All Urban Consumers (CPI-U), not seasonally adjusted, Mar. 2010 - Mar. 2011

Percent change



But will they? Can they? Look at the dilemma they face. Can you justify tightening monetary policy at a time when the economy is still fragile, with joblessness close to 9%, consumer spending softening and industry still operating below their full capacity?

Rarely has the Fed been in such a predicament. Currently, voting members on the FOMC are deeply divided on how to characterize the current behavior of inflation.

Are the forces now driving retail prices higher the result of transient events and thus of no long term consequence? Or has the global economy undergone changes that have fundamentally altered the dynamics pushing inflation higher?

The answer to this question is critically important because it has a direct bearing not only on Fed policy, but also on the decisions money managers, business leaders, and consumers make with respect to their financial and real assets.

We know there is visible disagreement inside the Fed on whether the sharp rise inflation should be taken seriously and if it justifies a change in monetary policy sooner rather than later.

One side on the Fed

One faction, led by Ben Bernanke, Janet Yellen and Bill Dudley, see no reason to tighten anytime soon. Core CPI for the year, though up 1.2% in March, is still fairly tame. The Fed's preferred target for core inflation is 1.5% to 2%, so there is still no reason to shift into tightening mode.

Moreover, this camp believes the recovery is still delicate and the unemployment rate way too high. The consistent climb in food and energy prices, they say, can be attributed mostly to temporary factors. After all, the world has experienced catastrophic floods, earthquakes and major droughts the past year and that has momentarily reduced global food supplies at a time when demand for such commodities have surged because of the rapid growth in emerging countries. Once agricultural output returns to normal, prices will ease again.

This group also argues that the sharp climb in energy prices can be attributed to geopolitical eruptions across North Africa and the Middle East --- two regions that together provide nearly one out of three barrels of oil in the world. That has led market speculators, according to our estimates, to tack on a $20 to $25 risk premium to each barrel of crude in the futures

market.

The Bernanke-Yellen-Dudley team also knows geopolitical shocks typically have only a short-term impact on energy prices and that monetary policy should not be based on such temporary fluctuations. The last thing they want to do is monetize the increase in oil prices because that is what helped launch the ugly inflation spiral of the late 1970s.

The Plosser and Fisher View

The other main faction at the Fed, led by Charles Plosser and Richard Fisher, respective presidents of the Philadelphia and Dallas Federal Reserve Banks, is far less sanguine. They believe the time has come to advance the schedule of tightening.

Why? For one, we may be witnessing a restructuring in the world economy where China, Brazil, India and many other emerging nations will drive up the demand for industrial and agricultural commodities for years to come, and thus continue to boost global production costs and retail prices everywhere.

Secondly, the geopolitical eruptions underway in the Middle East will not be going away anytime soon, not next month, not next year. These are profound, sweeping changes that may last for years. A prolonged period of instability here will likely keep oil prices elevated for a long time.

Most alarming to this group is evidence that inflation expectations itself is becoming unmoored. Such a trend would be a vote of no confidence in the Federal Reserve as the nations main guardian against inflation.

But are inflation expectations starting to loosen? There are enough reasons to think so and here's why. While monetary policy is based on the behavior of core inflation, how well inflation expectations are anchored appear more closely tied to the trend in headline inflation. Check it out.

- **In today's release on consumer sentiment by the University of Michigan, people were asked this month how high they expect inflation to rise in the next 12 months. They saw it jumping to 4.6%, the same as in March and the highest rate in two and half years!**

- **A similar question was posed by the Conference Board in March (their latest), and their results showed that Americans feared the CPI would jump to 6.7%!**

- **But let's not stop with households. Small companies in the latest survey by the National Federation of Independent Business**

say they, too, are increasingly burdened by rising prices and are now ready to counter it. The NFIB reported the number of firms prepared to hike prices is the largest in 30 months.

- **Look at the ISM surveys for both manufacturing and services and you see prices paid have been increasing every month for nearly two years!**

- **Gold, silver and other key commodities have been scooped up by investors because they are increasingly concerned about the corrosive effects of inflation on financial assets. Gold, in fact, hit a record high $1,480.50 this morning, and silver jumped to $42.715 an ounce, the highest price in more than three decades!**

- **Bond investors are getting agitated too. The spread between yields on 10-year notes and Treasury Inflation Protected Securities, a gauge of inflation expectations, reached 2.63 percentage points, close to the 2.67 percentage points on April 11 that was the most since March 2008.**

Bottom line:

It is thus getting harder and harder for the Federal Reserve to say with credibility, as they did in their March 15th FOMC statement, that “longer-term inflation expectations have remained stable.” Whatever they saw back then has since changed.

Indeed, the Fed just released March’s industrial production numbers and it turned out to be the strongest of the year. Output jumped by 0.8% last month, the fifth straight increase. Remember, this is actual output! It is not influenced by changes in prices. We’re talking strictly about the volume of products produced. Ramping up factory output will further increase demand for industrial commodities.

The Federal Reserve has to wonder whether this perception that it is falling behind the curve helped caused foreign investors to scale back their net purchases of US financial assets. The Treasury reported that foreigners cut their purchases of long term US assets in February by half, to $26.9 billion, from $51.1 billion. China and Russia reduced their US treasury holdings for the fourth consecutive month.

This has got to be disconcerting to Federal Reserve, Congress, and the White House. With inflation pressures building in the U.S. and the ongoing political circus over the budget and the lifting of the debt ceiling, foreign investors may be turning more cautious about buying more US debt ----and that would be dangerous. The US relies greatly on the kindness of foreigners to help finance our consumption and government deficits.

It is our thinking the Federal Reserve may be forced to move sooner than it desires to stem an increase in inflation expectations. While it has a number of tools at its disposal (e.g., lifting the fed funds rate, issuing term deposits, paying banks more for reserves held at the Fed, conducting open market repos, and selling assets from its balance sheet), the issuance of term deposits and market repos may be best ways to begin the delicate process of tightening. That's what we will be looking for in the summer or fall of this year.

We may get a chance to better see what the Fed is thinking in two weeks when Bernanke holds his first press conference ever following an FOMC meeting.

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