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ECONOMIC TALKING POINTS

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The Bernanke Press Conference: A Clever Strategy, But One Unlikely To Create New Headlines

The media build-up to the Federal Reserve's first official press conference is starting to rival that of the upcoming royal wedding in England.

Certainly we all want to hear how Bernanke responds to questions from reporters, but there is little chance it will produce in any major news. We essentially know where he stands.

Bernanke, along with Fed vice-chairman Janet Yellen and New York Fed Bank president Bill Dudley have argued the recovery still lacks sufficient depth and that the forces driving inflation higher are not likely to persist. That's why this powerful troika is not about to commence any monetary tightening action. There may not be a QE3 after June, but neither will the Fed dramatically reverse course and remove some of the excess reserves in the financial system. They won't act to tighten until there is concrete evidence the economy is on a sustained growth path, one that continues to make progress in narrowing the slack in labor and industrial capacity.

Inflation may be creeping higher, they admit, but that's OK. The economy dodged the bigger bullet of deflation recently. Another reason not to panic is that core inflation remains markedly below the Fed's own target of 1.5% to 2%. The latest reading on core PCE prices showed inflation up 0.9% over the year, even *less* than last year's pace. Finally, they say, the economy cannot generate much more inflation without a significant acceleration in wages --- and there is no evidence of that.

Those are essentially the main speaking points you will get tomorrow.

But not everyone on the FOMC is as sanguine on inflation. Voting Fed Bank presidents Charles Plosser and Richard Fisher have kept up the drumbeat that the rise in prices must be taken more seriously and that the moment to tighten is getting near. Prolonged inaction will cause inflation expectations to edge higher and that will quickly feed into core prices as well. The reason? There may be nothing transient about these food and energy price hikes, for they reflect the faster growth and wealthier consumers in the emerging economies. That strong source of demand can continue for decades.

There is another concern ---- although this is an argument that has not gotten as much attention. One can even question the conventional view that a wage and spiral is unlikely with the unemployment rate close to 9%.

Here's why. Look at how much the economy is already producing. If the output of goods and services is now as great as it was when the economy last peaked in December 2007 -— but with nearly 8 million fewer workers --- then you have to wonder whether the level of structural unemployment is much greater than anyone thought. This is deeply troubling since structural unemployment does not give you the same protective buffer against a wage and price spiral as does cyclical unemployment ---and that means the Fed may have to act much sooner. If they don't, a pick up inflation expectations can bring on a wage and price spiral earlier than usual.

Are inflation expectations actually turning higher? Has the Fed already lost the battle to keep such concerns well anchored?

The statistical evidence is mixed so far, which is not uncommon when you are approaching an inflection point. But the trend is worrisome. One indicator out today from the Conference Board shows that consumers

believe inflation will climb to 6.3% in the next 12 months. While that is slightly below the 6.7% they projected a month ago, it is still more than double where the CPI stands now and nearly four times that of the current PCE price index.

Another measure that alerts the Fed to inflation expectations comes form the financial markets by way of the TIP spread. The difference between the yield on the ten-year nominal Treasury note and that of the equivalent inflation protected security widened to 2.6%, the most in more than four years!

At the very least, both the Consumer Confidence results and the TIP spread provide evidence that inflation expectations are not as securely moored as they were months ago and that has to be disconcerting to Bernanke.

Curtains up tomorrow on the Fed

All this represents the backdrop for tomorrow's press conference. In addition, the Fed will release its latest economic forecasts, which will probably show business activity slowing this year and inflation edging slightly higher. A more interesting assessment, though, will be its outlook for the job market. We suspect the Fed will project faster job growth this year than in 2010. But that may be more a prayer than a forecast. It will be interesting to see how the Fed justifies an increase in hiring when the central bank is simultaneously predicting slower economic growth.

Why is it having this press conference at all?

Simple. The Federal Reserve has received fierce criticism from Congress for acting too slowly to prevent the last financial crisis, one that in some respects turned out to be worse than the Great Depression. Some on Capital Hill have argued the Fed was responsible for causing the crisis in the first place when it kept short-term rates too low for too long and ignored the housing bubble. While Congress has the power to revoke the Fed's charter altogether --- and a few key members favor such action ---most oppose this.

Still, the Fed's image took a beating. Tomorrow's press conference, whose ostensible purpose is to add more transparency regarding Fed policy, is really designed to help repair its image with the general public, a process that began when Bernanke first appeared on *60 Minutes*. The press

conference serves multiple purposes. It helps explain the Fed's role in the economy, improves public trust in the central bank, and can be used discreetly as a platform to place more pressure on Congress to reduce the swelling budget deficits.

Those who hope Bernanke will say something that violently shakes the markets will be disappointed. Since becoming chairman in February 2006, he has thoughtfully responded to tough questions from members of Congress and the public during innumerable speaking engagements. He even took reporter questions earlier this year at the National Press Club.

In the final analysis, Bernanke is doing something that has been fairly routine in Europe. If the ECB's Jean Claude Trichet and Bank of England chief Mervyn King can regularly tackle questions from reporters, it should be a fairly easy exercise for Bernanke. Indeed, we suspect the spotlight this first time will be less on the Fed chairman, and more on the reporters and how tough their questions will be.

As for the market's reaction to it, we suspect it will be muted.
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