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Is the Bernanke Fed on the Verge of Another Mistake?

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Weekly Market Beat

As has been the case since early May, "volatility" was again the name of the game last week. After having fallen 200 points through Wednesday, the Dow Jones Industrial Average regained its footing on Thursday and Friday, and finished the week ahead 0.8%. The S&P 500 was unchanged, and the Nasdaq lost 0.8%. Crude oil prices were $3 per barrel lower on the week, and the core (excluding food and energy) CPI was reported on Friday to have gained only 0.2% in May. Year-over-year, the total CPI has gained 4.2%, versus the annual gain in the core rate of 2.3%.

The real drama last week however was in the bond market, where the two-year Treasury note leapt 66 basis points to 3.04%. Since 1980, last week's rise was topped only by the 73 basis point increase in August, 1982 when interest rate volatility was at a generational extreme. Ten-year bond rates rose a sharp 34 basis points to 4.26%, their highest level this year.

Why all the fuss in bond land? Monetary officials across the globe are now being rattled by the persistent rise in commodity prices and their role in pushing future inflation expectations higher. Comments by European Central Bank (ECB) chief Jean-Claude Trichet two weeks ago suggesting that its policy rate could rise as early as July, was followed last week by Federal Reserve Chairman Ben Bernanke's statement about "… strongly resist[ing] an erosion of longer-term inflation expectations…" These views, along with a parade of public comments by other Fed officials have dramatically shifted the focus of bond market participants from the slowing economy and credit problems to a new-found fear that global central bankers are already sounding the alarm about inflation.

There is a worrisome *déjà vu* about this. If you recall, back in October the Federal Reserve surprised the market by only reducing the Federal funds rate by 25 basis points to 4.5%. Its October 31 announcement suggested that the Fed judged the risks to lower economic growth and higher inflation were about the same. Here are their words from the October 31, 2007 policy statement:

> "…..recent increases in energy and commodity prices, among other factors, may put renewed upward pressure on inflation. In this context….some inflation risks remain and [the Committee] will continue to monitor inflation developments carefully.
>
> The Committee judges that….***the upside risks to inflation roughly balance the downside risks to growth."*** (Italics mine)

This statement has been widely credited with the ensuing collapse in bank shares, as markets (rightly) judged that the Fed was woefully out of touch with the deterioration in market liquidity , the shuttering of the capital markets, sharp markdowns of banking asset values, and the pronounced downshift occurring in economic growth. To its credit, the Fed finally got their mojo back in succeeding months, establishing additional borrowing facilities, and following market interest rates lower, by reducing the Fed funds rate to 2% in the wake of credit failures and the Bear Stearns bailout.

Now, the renewed collapse in banking stocks over the past few weeks is a clarion call to a Fed that is again drifting toward unreality. They must tread carefully here. If the economy were near the point of re-accelerating, the Fed's hawkish rhetoric would be understandable, as they prepare the market for higher rates to contain *cyclical* (business cycle-related) inflation pressures. The economy is in the mud, bond yields have spiked to new yearly highs, oil prices are still near record levels, and the dollar is now rising. And the markets are already pricing in a rise in the Fed funds rate as early as October, underscoring that financial market conditions have already tightened without any lift in the economy.

The current upside is that the equity market as a whole, though struggling, has not come crashing down as occurred in November despite rising bond yields, the drag from record oil prices, and the Fed's latest adventure into virtual (un)reality. The near-term risks in stocks have risen with the threat that the Fed could repeat its October mistake. Our expectation is that, once oil prices begin to recede, bond market inflation worries will retreat, and the Fed will sound less hawkish. While this should allow equity prices to again resume their slow grind higher, the road from here to there has now become more rocky.

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