
The Idle Speculator™

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Update on Inflation & Interest Rates

Evidence continues to pile up against the inflation and interest rate doves this week. While ongoing cooling of the residential sector will continue to be a drag on economic growth, offsetting strength in other sectors of the domestic economy, and in the broader global economy, are causing inflation readings to print at stubbornly high levels. This supports the idea that the Federal Reserve's rate target may still be at too low a level relative to economic output, despite the pain it is causing in some areas of the economy. It also allows us to stick by our increasingly less contrarian assessment from December 2006 that global economic output is poised for another leg up, while a desperately hoped for Fed easing is nowhere in sight:

Despite the current soft patch, we continue to stand by our assessment that the domestic and global economies are still performing well, and that capital markets should remain relatively healthy as long as no significant new externalities come into play in the coming year. With that in mind, and given that price level stability is (or at least should be) the primary aim of monetary policy, we're standing by our expectation that the Fed will hold its position until enough indicators point to a levelling off of inflation somewhere around its unofficial comfort zone of 2%. (SCM, 2006)

Exhibit A – U.S. Import and Export Prices

This morning the Bureau of Labor Services released its March report on U.S. Import and Export Prices. Import prices excluding petroleum rose 2.9% year-over-year, while export prices excluding agricultural products rose 4.2% yoy. The report also indicates that the outlook for global output remains healthy:

A 1.9 percent increase in nonagricultural industrial supplies and materials prices was the largest contributor to the rise in nonagricultural prices. The advance followed a 2.0 percent increase in February and was driven by higher prices for metals, fuels, and chemicals. Over the past 12 months, the index rose 11.0 percent. (BLS, 2007)

Exhibit B – Federal Reserve Open Market Committee

The import/export price data lends additional support to ongoing concerns expressed by Federal Reserve officials and policymakers over inflation, as captured in this excerpt from the FOMC's March 21st minutes:

[I]nflation remained uncomfortably high, and the latest information cast some doubt on whether core inflation was on the expected downward path. (FRB, 2007a)

Exhibit C – Chicago Fed President Michael Moskow

In a speech yesterday, Mr. Moskow reiterated his longstanding concerns with inflation. In our view, the following comment should dash any lingering beliefs (fervent hopes?) that the Fed will soon lower its federal funds target, though we acknowledge that some dreams die hard:

Ultimately, expectations of inflation depend on the public's perception of the Fed's willingness to carry out monetary policy in a manner that will ensure price stability. (FRBC, 2007)

Exhibit D – A Hard Won Commitment to Price Stability

Finally, investors should not underestimate the emphasis that central bankers have learned to place on price stability, following severe theoretical and practical errors that led to widespread difficulties in the "stagflationary" 1970s and in the deflationary episodes that followed under Fed Chairman Paul Volcker. The rationale for price level stability was articulated in a recent speech by Fed Governor Fred Mishkin:

...there is now a broad consensus among policymakers, academic economists, and the general public in support of the principle that *maintaining a low and stable inflation rate provides lasting benefits* to the economy. In particular, *low and predictable inflation promotes social welfare* by simplifying the savings and retirement planning of individual households and by facilitating firms' production and investment decisions. Furthermore, an environment of *overall price stability contributes to economic efficiency* by reducing the variability of relative prices and by minimizing the distortions that arise because the tax system is not completely indexed to inflation. Price stability also has important benefits in terms of equity. For example, *an elevated inflation rate typically increases poverty* because the poorest members of society do not have access to the sorts of financial instruments that would help protect them against inflation. By the way, these are not just theoretical arguments: The experience of the United States in the 1970s, and that of many other economies across a wide range of times and circumstances, demonstrates that *high and unstable inflation generally detracts from the standard of living, hinders the process of capital formation and economic growth, and in some countries has even led to political and social instability*. Such episodes also show that *a full recovery from the adverse effects of severe inflation can take many years*. (FRB, 2007b) [emphasis added]

Conclusion

We draw the following conclusions from the evidence presented:

- Inflation data continues to indicate rising price levels.
- The FOMC continues to watch these data very closely.
- Fed officials continue to raise concerns about inflation.
- In the intermediate to longer term, the FOMC is more likely to favor price level stability over marginally higher employment.

On the basis of these observations, we continue to believe that the Fed is unlikely to lower its target rate anytime soon. In fact, despite current Eurodollar futures prices to the contrary, the probability of a rate *hike* may still be as high as or higher than that of a rate cut, assuming the economy does not encounter any significant external shocks.

Sources

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FRBC (2007) "Remarks by Michael H. Moskow, President and Chief Executive Officer, Federal Reserve Bank of Chicago" http://www.chicagofed.org/news_room/speeches/2007_04_11_kuc.cfm

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