

Inflation and Fed Policy

Arthur A. Micheletti, CFA
Chief Economist and
Investment Strategist

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The recent market volatility was triggered on April 27 when new Fed Chairman Ben Bernanke testified before Congress, saying that the Federal Open Market Committee (FOMC) may skip a meeting without raising rates and wait for more data to see what the impact of past rate hikes was having on the economy. It seemed like a sensible view, but it was interpreted by the markets as a signal that the Fed was turning dovish on inflation. Since then, on an almost daily basis, Fed officials have rushed to any available open mike to say that inflation is either outside or at the top of their "comfort zone." The equity markets interpreted these comments to mean that inflation is a more severe problem than previously believed and that the Fed would have to drift into monetary overkill to contain it.

Unfortunately, the markets have chosen to ignore other parts of the Fed statements. This suggests the markets believe that the current Fed Funds Rate is high enough to moderate economic growth, and that they expect energy prices to drop or flatten out, productivity to remain strong, pricing power to be limited and wage gains to stay modest. All this is consistent with an improvement in the inflation outlook.

Current Inflation Measures

As the table to the side indicates, almost every measure of inflation has moved

higher and is now outside the Fed's comfort zone (1.5%-2.0%). In a recent speech, Ben Bernanke suggested that, like his predecessor Alan Greenspan, he leans toward the core (ex-food & energy) personal consumption deflator over a three-to-six month time frame as his preferred measure of inflation. We believe that three-month measures can be misleading, but he's the Fed chairman. Using this measure, core inflation is running at 2.4%, up from 2.1% over the last year and 1.8% over the last three years. While outside "the comfort zone," it is hardly cause for alarm.

The Fed and investors will continue to monitor the more traditional measures of inflation as well. Rising energy prices are clearly boosting headline CPI and PPI, but core inflation has also ticked up during the past three to six months. However, the increase in the core CPI can be largely attributed to a large and abnormal increase in Owners' Equivalent Rent (what owners could rent their homes

for) that appears to be a statistical anomaly.

There are a lot of ways to slice and dice these numbers, but the bottom line is that inflation has primarily been isolated to the energy sector, energy prices appear to have peaked and the tick-up in core inflation is mostly statistical in nature.

What Are the Markets Saying About Inflation and Fed Policy?

The Fed knows it needs to be forward looking and can't drive monetary policy by looking in the rear view mirror. Inflation is a lagging indicator and it is perfectly normal for it to drift higher even after the Fed ends its tightening cycle. If the Fed waits for confirmation that inflation has turned down it risks putting the economy into a tailspin. That is why the Fed also looks at other measures than just the current inflation number in setting its policy.

annualized inflation measures

	may 2006	3 months	6 months	12 months	36 months
cpi	0.4%	5.7%	4.2%	4.1%	2.9%
cpi core	0.3%	3.8%	2.9%	2.4%	2.0%
ppi	0.2%	6.7%	2.5%	4.3%	4.0%
ppi core	0.3%	2.0%	2.7%	1.9%	1.6%
pc deflator core*	0.2%	2.4%	2.4%	2.1%	1.8%

*april 2006

Musings From the Chief Economist

There are plenty of other inflation indicators such as productivity, unit labor costs, the employment cost index, bond yields, breakeven inflation derived from inflation index bonds, the Fed Funds Futures curve, commodity prices, gold, the dollar, stock prices in general, inflation-sensitive stock sectors, inflation surveys and inflation rates around the world. Most, if not all, of these indicators are suggesting that the economy is slowing, inflation expectations are contained and the Fed should move to the sidelines.

What is the Big Picture View of Inflation?

Although we are seeing tighter labor markets and capacity utilization in the U.S., the secular view of inflation remains very constructive. Globalization, the opening up of new markets and free trade have made domestic resource utilization less important as a driver of prices. Prices are set in the global economy. Excess global capacity and plentiful low cost global labor mean cheap imports and limited pricing power in the U.S. To compete, U.S. companies need to continuously enhance productivity. Technology-driven productivity, combined with low wage pressure keeps unit labor costs down and profits up without pushing prices higher. Other cost saving initiatives, such as mergers and corporate restructuring, are helping to rationalize cost structures and allow corporations to limit pricing pressures.

In addition to global competition, mass distribution and the Internet are helping to contain consumer prices, providing access to the best goods at the cheapest price. Finally, around the world we continue to see ongoing vigilance and monetary discipline that is helping to contain inflation expectations and creating a "wait-to-buy" psychology.

Both the cyclical and secular outlook for inflation remains positive, which should help to sustain the economic expansion. The greatest risk to the recovery in our view has always been a policy mistake in which the Fed or financial markets over-react to a transitory increase in inflation. Although the Fed is likely to raise rates at the next meeting, we believe the economy can withstand 25-50 bp (0.25%-0.50%) of further tightening, but they are probably unnecessary.

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Bailard, Inc.
950 Tower Lane, Suite 1900
Foster City, California 94404