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Your guide to understanding today's economy and financial markets

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Shift

Written by Jeff Thredgold, CSP, President, Thredgold Economic Associates

Place an asterisk on June 9, 2008 as a key date on your financial calendar. That is roughly the date wherein the Federal Reserve undertook a major shift in monetary policy. The Fed's primary focus has now shifted from A) providing liquidity and monetary ease in whatever amount necessary to deal with one major domestic and global financial and economic crisis after another, to B) making it clear that its primary focus is now inflation containment.

In the eyes of many critics, this change was a bit too slow in coming. These would be the same critics who loudly blasted the Fed late last year for its tardy and meager cuts in its key short-term interest rate when stronger medicine was perhaps needed. Hindsight is still 20/20.

The Fed and its battle-weary Chair Ben Bernanke are now back on the more familiar turf of fighting inflation and—more importantly—controlling inflation expectations. To his (no doubt) dismay, Bernanke has been involved during the past 11 months in unique financial arrangements and one-of-a-kind financing packages that were clearly nowhere to be found in the Fed's play book. Nor were such extraordinary steps perhaps in anyone's view of what is "appropriate" for a central bank to dip its collective fingers into…

…financial crises can have such an impact

"The risk that the economy has entered a substantial downturn appears to have diminished," noted Bernanke during a presentation at a Federal Reserve conference in Boston on June 9. *"The Federal Open Market Committee* (the policy-making group within the Fed) *will strongly resist an erosion of longer-term inflation expectations."*

Beginning last August, Bernanke and other major central bankers around the globe must have felt like the silver balls in a pinball machine, constantly getting sent in differing directions to face the latest major threat to global financial markets. While much of the media's focus during the past 16 months has been on sub-prime mortgage lending abuses, much more serious and threatening developments also arose.

Federal Reserve Chair Ben Bernanke

Too many sub-sectors of global financial markets simply stopped working. While many of these sub-markets are now performing better, serious threats remain with numerous markets still operating awkwardly…

…just ask those investors whose funds are still unavailable in auction rate securities, a form of short-term investment not-so-long-ago considered nearly as safe as cash

A Rock and a Hard Place

Even as the Fed undertakes this shift in focus, the path will be littered with obstacles. The Fed cannot force energy prices lower. It can, however, tighten monetary policy enough to minimize the impact of high energy costs on longer-term prices.

Financial markets are already "pricing in" expectations that the Fed's next change to its key short-term interest rate—the federal funds rate—will be to move it higher. The federal funds target rate has been at 2.00% since April 30, following seven rate cuts totaling 3.25%.

Some suggest the Fed could push its key rate higher as early as August 5, although most forecasters suggest that the Fed is more likely to keep the rate unchanged until later in the year…or early in 2009.

Reality suggests that a weak U.S. economy, sagging home values, declining employment, and rising joblessness are not exactly a recipe to justify higher short-term interest rates. At the same time, Fed officials know that if global financial markets freeze up again, or if stress upon financial institutions returns to crisis levels, the Fed may actually need to respond with greater monetary stimulus, i.e. even lower short-term interest rates.

Rising Inflation

Recent U.S. inflation data illustrates the challenge faced by the Fed. The Consumer Price Index (CPI) rose 0.6% in May, the largest rise in six months, following a 0.2% rise in April. The CPI has now risen 4.2% over the most recent 12-month period. Note that the 4.1% rise in the CPI during 2007 was the largest rise since the early 1990s.

The "core" CPI (which excludes volatile food and energy prices, an inflation measure for those who don't eat or drive) rose a more palatable 0.2% during May, with the 2.3% rise over the past 12 months more in line with the Fed's desired 1.0%-2.0% range.

Market Reactions

Two financial markets had contrasting performance in recent days resulting from the Fed's shift. Bond prices fell sharply, while interest returns (yields) on bonds jumped sharply.

The two-year U.S. Treasury note yield spiked from 2.37% on Friday, June 6 to 3.02% on Friday, June 13. This represented the largest weekly jump in the two-year Treasury note in 12 years.

The yield on the 10-year U.S. Treasury note jumped from 3.91% on June 6 to 4.26% on June 13. Note that the yield on the 10-year Treasury (plus around 2.00%) is the primary indicator of rates on 30-year fixed-rate mortgages. Higher mortgage rates won't exactly help the housing crisis.

Bond yields moved higher last week in response to higher inflation pressures and rising recognition that the Fed would like to withdraw excess monetary stimulus (push its key rate higher) over the next year, should conditions allow.

In contrast, the U.S. dollar strengthened versus other major currencies. Last week, the dollar had its best week in three years versus the euro, with solid gains against the yen as well. I have regularly been telling audiences across the U.S. I have had the opportunity to speak for during 2008 that I expect the dollar to strengthen versus other major currencies as the year progresses.

Team Effort

The Fed is not alone in its newfound focus on inflation containment. Other central banks around the globe are also seeing opportunities to turn their primary attention away from the global credit squeeze and toward constraining inflation.

Financial ministers representing the Group of Eight nations indicated earlier this week that surging food and fuel prices now represent the global community's greatest challenge. In addition, Bloomberg.com noted that the International Monetary Fund (IMF) predicts that inflation during 2008 in advanced economies will be the highest since 1995, even as global economic growth in 2008 could be the weakest in seven years.

Jeff

"TEA"ser

Always end the name of your child with a vowel, so that when you yell the name will carry.

—Bill Cosby

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