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Economic Commentary

The Canary Chirps Again

Immediately following the release of the Fed's statement yesterday, which took a much more dovish stance against inflation than a few weeks ago, gold prices surged and the dollar plummeted. Like a canary in a coal mine, these market movements indicate that a "pause" by the Fed in its rate hiking campaign would be an inflationary mistake.

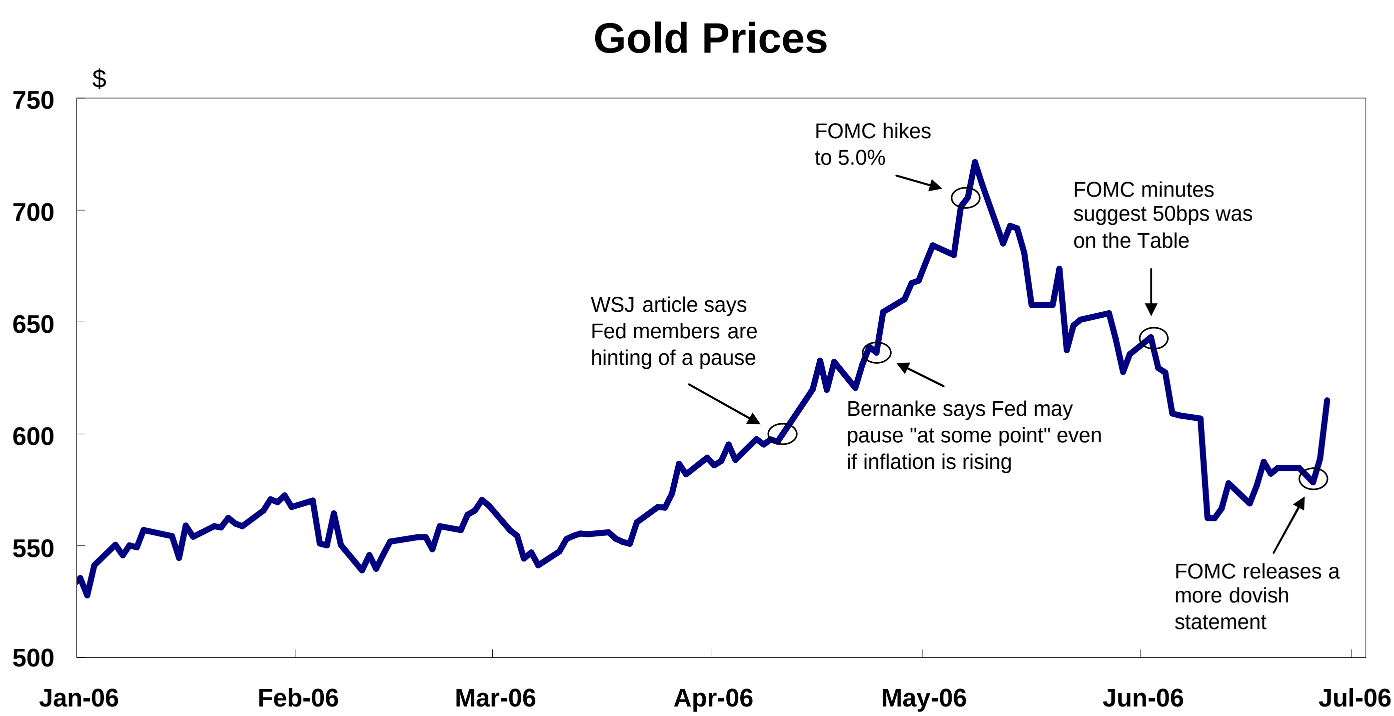
Before advanced technologies, coal miners used caged canaries as a signal for the build-up of dangerous gases. If the bird died or had problems breathing, the miners knew there was a problem.

For inflation, the canaries are commodity prices and the value of the dollar. The sensitivity of these markets to detect monetary policy ease or restrictiveness has become very clear in the past decades. If the Fed prints too much money, commodity prices rise and the dollar falls. When the Fed is too tight, the opposite happens.

The price of gold fell from roughly $400/oz. in 1996 to less that $260 in 1999. Other commodity prices also fell, while the dollar surged to its highest level in decades. Despite these early warnings from gold and the dollar, the Fed was still blindsided by a brush with deflation in the early 2000s. It did not pay attention to the canary; and this was a huge mistake.

Since 2001, with the Fed fighting deflation, gold and other commodity prices have been on the rise and the dollar has been falling. These are early signs of an overly accommodative monetary policy, and it should not be surprising to see "core" measures of inflation beginning to rise. Nonetheless, many on the Fed and a large contingent of private sector and academic economists downplay the signals sent by these markets.

One typical argument is that commodity prices play only a small role in the US economy, especially as services grow relative to manufacturing. But this argument misses the point. It is not the feed-through of rising commodity prices (even oil) that causes inflation. Rather, it is easy money that causes inflation, and the sensitivity of these markets to dollar liquidity means that they provide the earliest warning sign of a Fed mistake. Commodities and currencies are traded every moment of every trading day and their prices are finely calibrated with the supply of dollars in the system.



Interestingly, these markets are also highly sensitive to perceptions of Fed policy. This can be clearly seen in recent weeks and months. On Good Friday (4/14/2006), *The Wall Street Journal* ran a story written by Greg Ip (widely thought to be a mouthpiece for the Fed) which said that a pause at 5.0% was very likely. This reporting started a stampede into gold and out of the dollar.

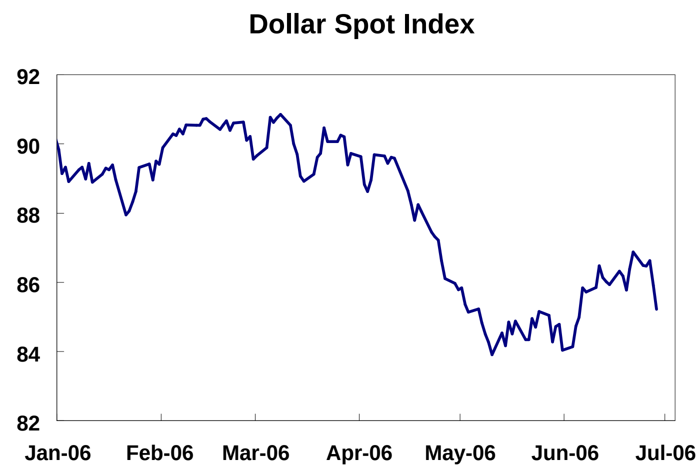
Ben Bernanke helped this when he said the Fed may pause "at some point" during testimony to the Joint Economic Committee on April 27, 2006. Gold, which was trading just under $600/ oz. on the day before Good Friday, shot to $720/oz. during the next four weeks. During this same period, the dollar index fell more than 6.5%.

Then, Chairman Bernanke and other Fed members began to send out more hawkish signals about Fed policy. The Fed minutes for the May meeting were released on May 31st and those minutes admitted that a more aggressive 50-basis point rate hike was discussed. The markets immediately turned around. Gold fell back below $600/oz., while the dollar moved up by 3%.

These movements in market prices were based on perceptions of Fed policy. If the market perceives that an inflationary mistake might be made, it drives commodity prices up and the dollar down. When the market perceives that the Fed will do what it takes to end inflation the opposite will occur.

Following yesterday's rate hike and statement, which signaled that the Fed was more worried about the economy slowing than inflation rising, gold prices have surged by $37 to $616/oz., while the dollar has fallen by roughly 1.5%. In other words, these sensitive markets are sending a signal that a "pause" at this juncture would be a mistake.

The movement of these sensitive markets in recent weeks suggests that the Fed is very close to "neutral." Our models indicate that a "neutral" federal funds rate is 6%. The faster the Fed pushes rates to that level, the sooner inflationary pressures will abate.



While it appears that the equity market wants the Fed to pause, a "neutral" monetary policy is the still the best environment for the US stock market. A neutral rate will snuff out inflationary pressures without harming the economy. We continue to believe that the Fed will listen to these market signals and push the funds rate to neutral. When the Fed reaches this level, the canary will live to see another day of "workin in the coal mine." Have a great Fourth of July.

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