

## Economics

**The Slow Spiral to Stagflation**

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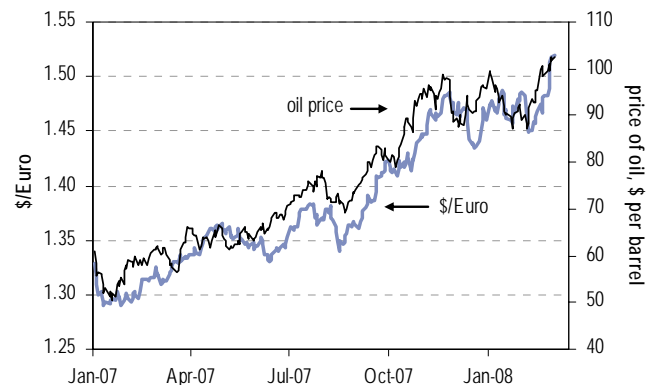
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The economy appears to be continuing its slow spiral towards stagflation. On the one hand, the latest data on the real economy point to an increased risk that the economy has already slipped into recession, as initial jobless claims continue to rise and manufacturing indicators point to contracting activity. On the other hand, the inflation data in January continued to deteriorate as we documented in last week's scribbling, "Inflation Chickens Coming Home to Roost?" We are beginning to see increased support for the stagflation view and we particularly welcomed noted monetary economist and Fed historian Professor Allan Meltzer's recent Op-Ed in *The Wall Street Journal* ("That '70s Show," February 28, 2008). Professor Meltzer warned "Surely Mr. Bernanke and his colleagues remember what happened in the 1970s. They console themselves with the belief that they will respond to any inflation that occurs by promptly raising interest rates. That repeats the commitments made repeatedly in the 1970s, which the Fed was unwilling to keep. The blunt fact is that there is rarely a popular time to raise interest rates. And with the growing streak of populism in the country, it will become more difficult." Rather than heeding Meltzer's words, Chairman Bernanke disagreed with Meltzer in Humphrey-Hawkins Q&A last week, saying "I would dispute his analysis on the grounds that I do believe that monetary policy has to be forward-looking, it has to be based on where we think the economy and the inflation rate are heading. And as I said, the current inflation is due primarily to commodity prices—oil and energy and other prices that are being set in global markets. I believe that those prices are likely to stabilize, or at least not to continue to rise at the pace that we've seen recently. If that's the case, then inflation should come down and we should have, therefore, the ability to respond to what is both a slowdown in growth and a significant problem in the financial markets." In other words, inflation is not the Fed's fault and it is going to fix itself!

*Core Crazyness*

When is the Fed going to recognize that trends in energy and food prices, in part, have a U.S. monetary policy component? Oil, for example, is a real commodity, which is priced in dollars. If the Fed runs monetary policy in a way that undermines the value of the dollar, then the dollar-denominated price of oil will rise. When the Fed took its first step to re-orienting policy to address the funding problems in the financial markets on August 17, 2007, the price of West Texas Intermediate (WTI) oil was \$71.0 per barrel. Yesterday, WTI crude closed at \$102.5—an increase of 44% in dollar terms. However, over the same period, the dollar has fallen almost 12% against the euro and the euro-denominated

price of crude has risen 27% over the same period. By not easing policy, the ECB has reduced the inflationary impact of higher oil prices. Moreover, as an inspection of Figure 1 suggests, the dollar price of oil and the dollar-euro exchange rate appear to share a common factor—the stance of U.S. monetary policy. In addition, the price of oil has not been a transitory shock, as oil prices have outpaced core CPI in each of the last six years. Indeed, the average increase in WTI crude over this six-year period has been 29.6% per year. One of Bernanke's arguments for lower energy prices is the futures market, which is pricing a relatively flat price for crude oil in 2008. However, in five of the last six years, this market has underestimated the increase in crude prices from anywhere between 25% and 80%!

**Figure 1. WTI Crude vs. Dollar-Euro Exchange Rate**

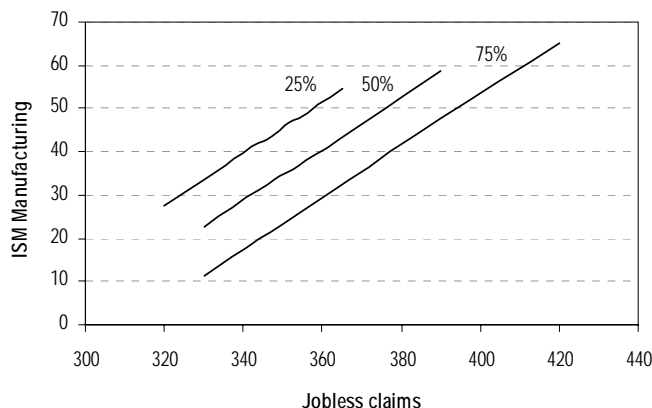
Source: Federal Reserve, WSJ

Food prices are also becoming a more persistent source of upward price pressure. Agricultural prices received by farmers have risen in five of the last six years—by as much as 20.0% in 2007. If the Fed targets core inflation and food and energy prices continue to rise, it follows that headline inflation will continue to rise at a fairly rapid rate. More importantly, while Bernanke blames global demand trends—especially in emerging markets—for higher food and energy prices, he might want to give thought to the impact that U.S. monetary policy is having in boosting global liquidity through the U.S. current account deficit and the foreign exchange reserve accumulation policies of countries whose currencies are pegged to the dollar. Over the last 12 months, global foreign exchange reserves have risen a whopping 27.1% and we find it difficult to imagine that such rapid reserve growth is being effectively sterilized.

*Recession Risk*

The jobless claims and ISM data for February thus far point to a rising risk that the economy has slipped into recession. Initial jobless claims for the last week of February rose to 373,000 (although the average level of claims for the month thus far was 361,000) and the February ISM manufacturing index fell to 48.3 from 50.7 in January. A logit model that uses these two inputs to predict the state of the economy (recession=1, not in recession=0) puts the probability of recession just a little bit shy of 50-50. An average claims level of 372,000 combined with an ISM reading of 47.7 equates to a 50% probability that the economy is in recession (see Figure 2). With this model on the cusp of indicating recession, Friday's employment report could prove to be very important in making a recession/no recession call.

**Figure 2. Recession Probability Contours**



Source: Bear Stearns

Bernanke's Humphrey-Hawkins testimony and most other recent Fed speak did nothing to dissuade the markets that there are more rate cuts coming. Bernanke stressed the downside risks to the economic outlook as he said "The risks to this outlook remain to the downside. The risks include the possibilities that the housing market or labor market may deteriorate more than is currently anticipated and that credit conditions may tighten substantially further." Bernanke also returned to the risk-management theme for policy, saying "Therefore, our policy stance must be determined in light of the medium-term forecast for real activity and inflation as well as the risks to that forecast. Although the FOMC participants' economic projections envision an improving economic picture, it is important to recognize that downside risks to growth remain. The FOMC will be carefully evaluating incoming information bearing on the economic outlook and will act in a timely manner as needed to support growth and to provide adequate insurance against downside risks."

Bernanke's frequent academic co-author, Governor Fred Mishkin, who earlier in the year outlined the "timely," "decisive," and "flexible" policy strategy, sounded extremely dovish in a speech given today on "Outlook and Risks for the U.S. Economy." We are particularly concerned that Mishkin

dismissed what former Fed insiders have suggested is an important inflation indicator for Fed policy, namely the 5-year, 5-year forward implied inflation breakeven. Brian Sack, formerly of the Fed and now of Macroeconomic Advisers, in wire service interviews has drawn attention to the importance of this indicator to the Fed and said that a reading above 3% "puts them on yellow alert." This inflation-breakeven measure rose to 3.0% in mid-February from a low of 2.6% in early January. However, Mishkin was dismissive of this measure today, saying "My best guess is that much of the rise in inflation compensation reflects other factors... I expect inflation pressures to wane over the next few years, as product and labor markets soften and the rise in food and energy prices abates. In addition, I continue to believe that long-run inflation expectations remain consistent with increases in PCE prices in the neighborhood of 2% per year. Accordingly, I anticipate that over time core PCE inflation will move back to around 2%. The risks around this outlook appear to me to be balanced, although the uncertainty surrounding the outlook may have widened recently, consistent with the apparent rise in the inflation risk premium."

**Figure 3. TIPS-Based 5-year, 5-year Forward Inflation Breakeven**



Source: Federal Reserve

In the wake of this kind of guidance from the Fed, expectations have shifted towards a 75 bp rate cut on March 18 (using the April fed funds contract gives a 70:30 weighting between 75 bp and 50 bp). Should the market keep such a cut priced in when the meeting date is upon us, we doubt the Fed would disappoint and deliver less. However, in dismissing what is perceived as an important and potentially troubling inflation indicator, the Fed could lose the back end of the Treasury yield curve and actually push long-term yields higher—thus raising mortgage rates. Ten-year yields rose 10 bp in the wake of Mishkin's speech today and the yield curve continued to steepen with the two-tens yield spread now only 3 bp shy of 200 bp. Moreover, in talking down the economy, the Fed may also be at risk of reducing private sector expectations of future growth—potentially hurting credit spreads and further pressuring equity prices. Gold prices have recently flirted with \$1000 an ounce and, in our

judgment, this indicator is flashing more than a yellow alert on the inflation front. If this were an episode of *Star Trek*, Captain Kirk would have given the “Shields up” command

and, given the weakness in the dollar, it looks as if investors in U.S. assets are raising their inflation shields. Beam us up, Scottie!

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