

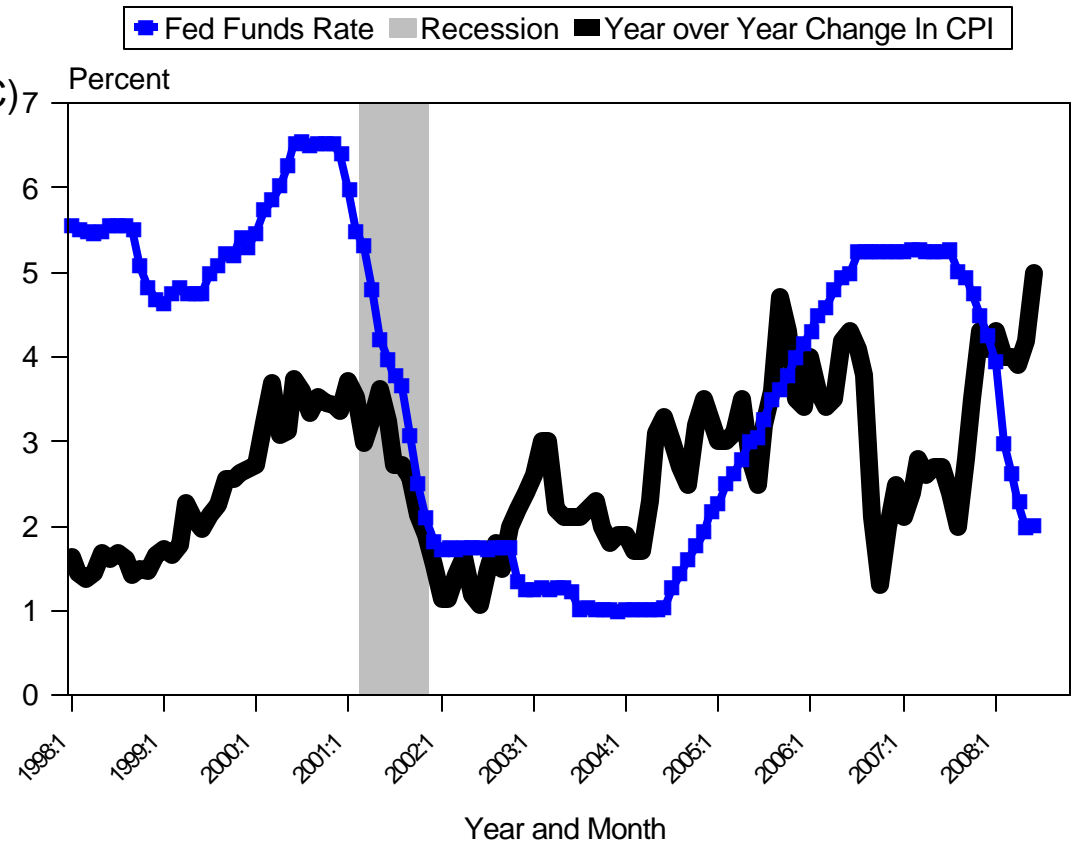
What will the Fed Do Next?

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July 23, 2008

Inflation and Interest Rates

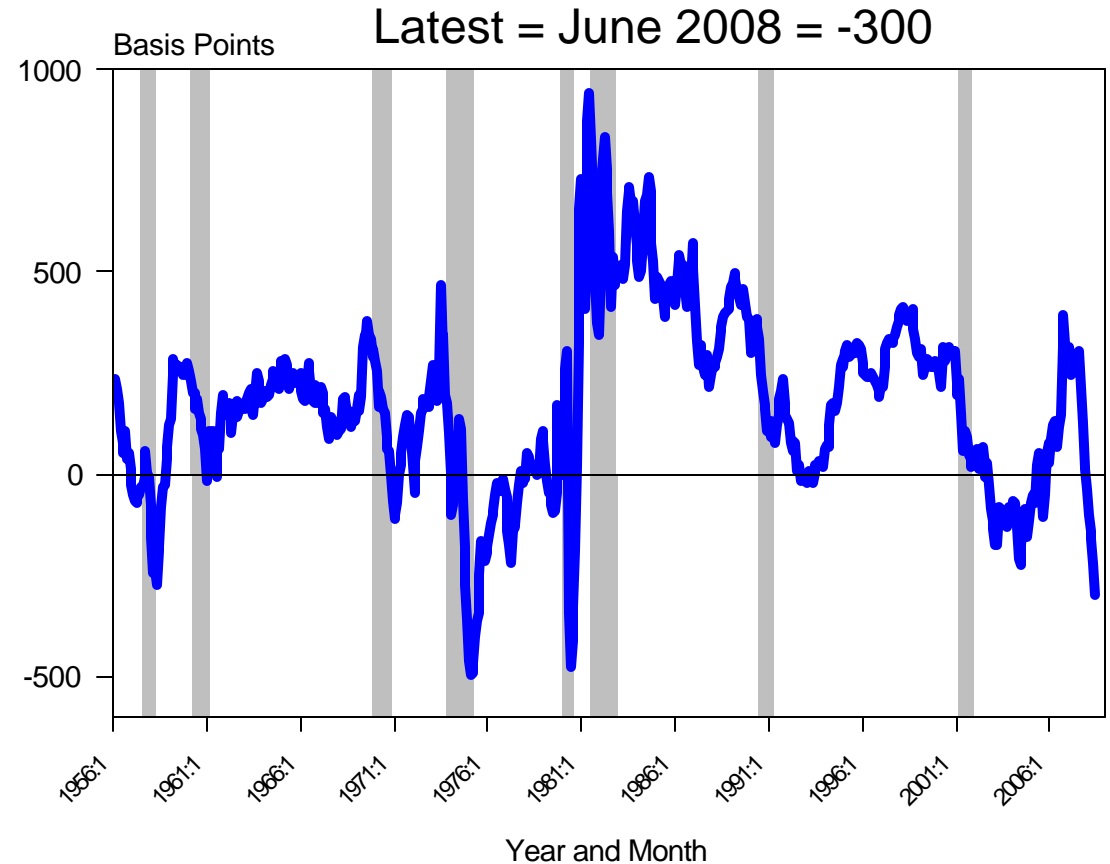
- The Federal Open Market Committee (FOMC)⁷ finds itself in an unenviable position. The inflation rate is higher than the Fed Funds rate.
- This is the result of the slashing of the Fed Funds rate last year to cope with the opening stages of the financial system crisis and the simultaneous spike in energy prices,
- It is a situation that cannot be allowed to prevail.
- What to do?



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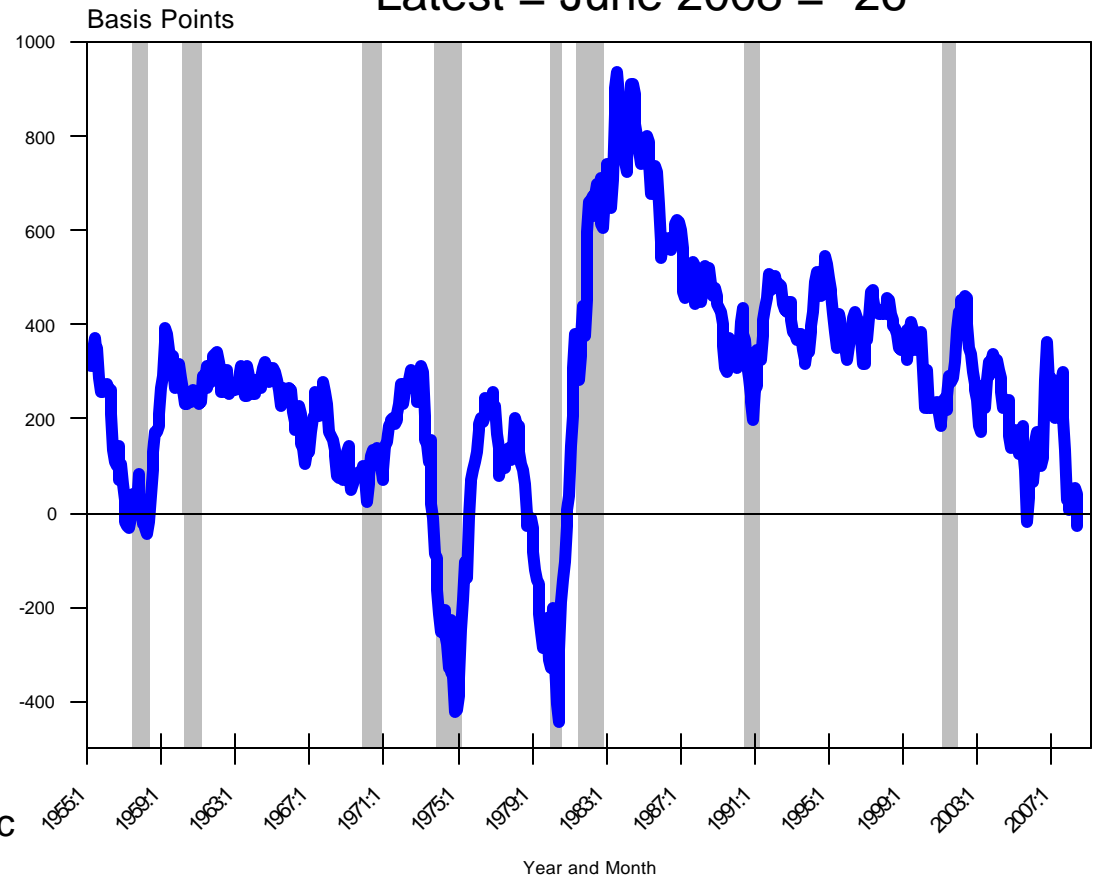
Federal Funds Rate Minus CPI Inflation Rate

- The first reason why the situation cannot be allowed to prevail is on this chart.
- The last time the inflation rate was above the Fed Funds rate for any length of time was during the bad old days of stagflation in the 1970s and early 1980s.
- It took four recessions to solve the problem last time, and the FOMC does not want to go down that road again.



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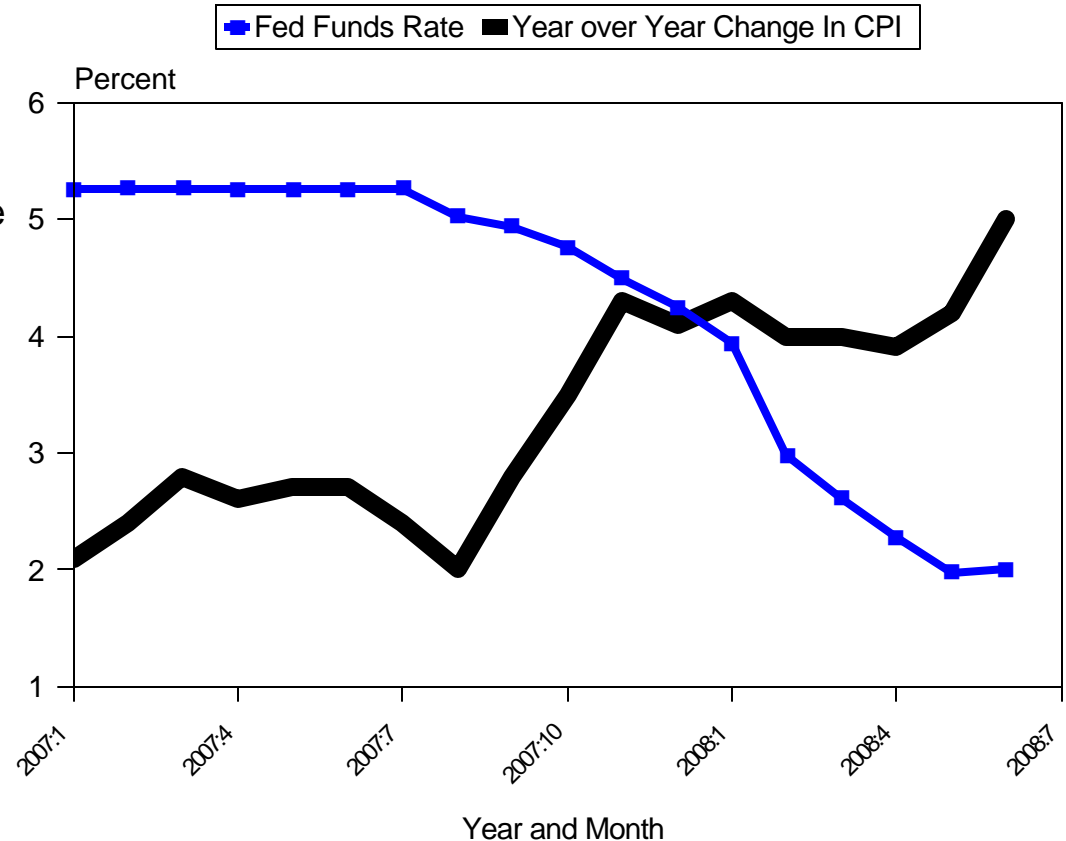
Long Treasury Yield minus CPI Inflation Rate Latest = June 2008 = -26



- The second reason why the situation cannot be allowed to prevail is on this chart.
- Here we see that the inflation rate is also higher than the interest rate being earned on Long Treasury securities. In other words, long-term investors are not being paid for the inflation risk they are taking. As the chart shows, the last time this happened investors demanded a large inflation premium for the next decade.
- Since all long-term capital ultimately is priced off the rates on the Treasury yield curve, the FOMC knows that the longer investors insist on high inflation premium, the higher the cost of capital will be.
- High capital costs make it harder to fund projects, which retards the rate of economic growth.

- In his most recent Congressional testimony, Chairman Bernanke stated that he expects the inflation rate to moderate during the second half of the year.
- The question will be by how much. Even assuming the inflation rate were to fall by half -- which it could if energy prices drop sharply -- we would still have an inflation rate of 2.5% at year end.
- Even with that improvement, the rate would still be higher than the current Funds rate.
- So, we expect the FOMC to have to raise rates by at least 100 basis points in order to get the lines to go back into their proper positions.
- It is unlikely that they will begin that process at their August 5 meeting, but there is a very good chance they could start when they meet on September 16.

Inflation and Interest Rates



For more information, check out the July 2008 edition of the Overview and Outlook Report.

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