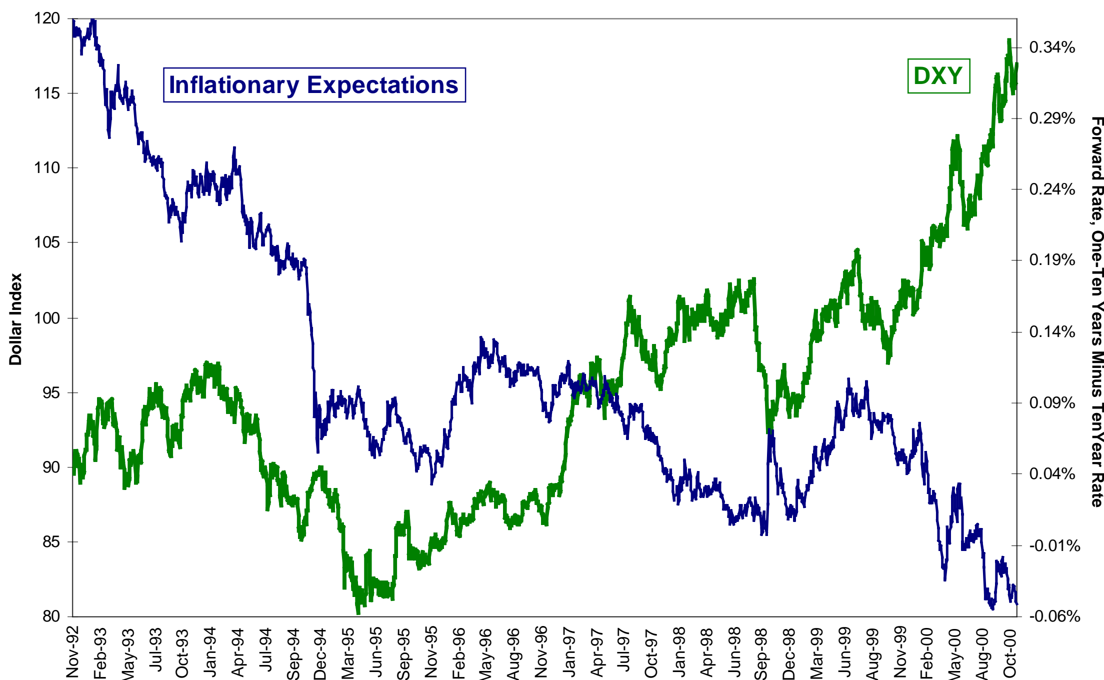
The Most Dangerous Game

Is this a great time to be an American, or what? How many other countries can boast of a central bank that, in the face of a Future Inflation Gauge (FIG) that has been falling and falling rapidly for six months can warn darkly about inflation risks? Or, just to keep you on your toes, can include in its October minutes a discussion of how a falling dollar imposes inflationary risks 1) while the greenback is at its highest levels since the mid-1980s, and 2) while the U.S. joined other nations in driving down the dollar against the woebegone euro as recently as September 22?

Sometimes the Fed's obfuscations are amusing. This time they're dangerous.

It's The FIG, Newton!
The Fed is rumored to watch the Economic Cycle Research Institute's FIG closely. The FIG has eight components, including industrial materials prices, growth in real estate loans, unemployment, employment growth, the shape of the yield curve, growth of total debt, the price of imports excluding fuel, and the speed of vendor deliveries. The FIG shot from 109.9 in April 1999, just before the Fed started to raise rates, up to a peak of 125.1 in April 2000, just before the last of their six rate hikes. The index has since fallen to 117.1, about where it was a year ago. If this indicator is flashing a red light, it is certainly doing so in a strange manner.

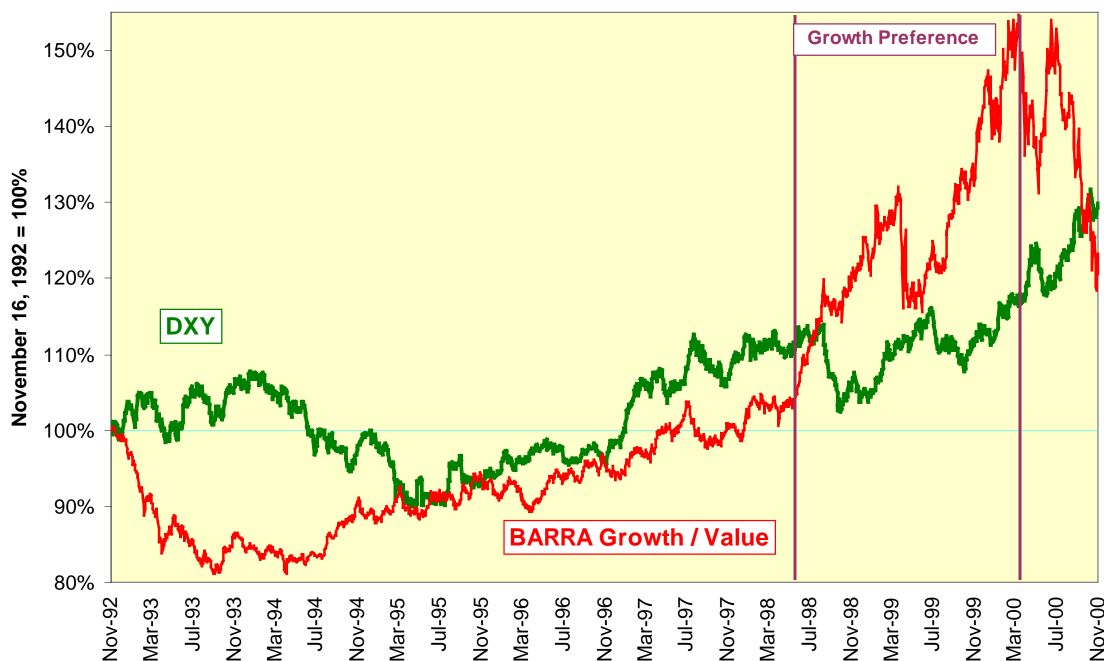
Whistling DXY
The Fed's point on the dollar is well taken. Not only does a strong currency lower the price of imports, a FIG component, but it sends a signal to foreign investors that their holdings will not be decimated by a sudden depreciation of the currency. European investors especially have gotten a boost since by selling euros and investing in dollar-denominated assets. A strong currency lowers inflationary expectations. The generally inverse relationship between the trade-weighted dollar index (DXY) and inflationary expectations as defined by the premium of the forward rate between one-year Treasury bills and 10-year Treasury notes over the 10-year rate is quite apparent, as seen below.



The Fed may be concerned that the dollar will be susceptible to a sudden downdraft once it reverses its credit tightening policies. This was one of the experiences of the 1985-1987 period, others being a moonshot in stocks and a collapse in the bonds, at least until the October 1987 crash. A dollar weakening under the influence of a looser monetary policy, if and when, may even precipitate a rush by foreign investors to sell, especially the pricier American stocks, while the selling's good. Is this what the Fed fears?

A Self Fulfilling Prophecy

The Fed's policies certainly distorted investor preferences during the late 1990s. As it maintained a loose policy in the aftermath of the Asian crisis, global investors sought safe and liquid American equities, many of which were export-sensitive multinationals. The dollar remained in a range under this monetary policy. From mid-1998 to spring 2000, the BARRA growth index surged relative to the BARRA value index. Much of this outperformance by growth occurred in the face of rising interest rates, an economic environment supposed to favor the steadier earnings of value issues.



That was then, this is now. The chart of the growth index relative to the value index looks like that of a classic double top on a commodity chart. The flight from growth is occurring simultaneously with declining bond rates, an inverted yield curve, a slowing economy -- and an upside breakout in the dollar. Whether as a reason or an excuse, many U.S. multinationals have cited the strong dollar for their earnings shortfalls.

Do The Right Thing, Please

The situation hardly can require more finesse. The Fed needs to bring interest rates down to avoid a collapse of the corporate bond market, a deflation of growth issues, and a too-strong greenback. It risks, however, sending a signal to the market that the "Greenspan put," the Fed riding to the rescue, is still alive and well. The prattle about inflation risks is just that. The real issue here is maintaining America's entrepreneurial fires and willingness to assume risk; this spirit has been the backbone of economic growth since 1982.

Central banks never have succeeded at deflating asset bubbles delicately, as our Japanese friends would surely attest. The Fed's concern over financial asset valuations in the late 1990s led them, deliberately or by accident, to focus on stock prices as a source of inflationary pressures. Nothing could be further from experience; the horrid stock market of the 1970s was accompanied by high inflation, and the strong markets of the 1980s and 1990s were accompanied by disinflation.

The Fed's job is to maintain stable price levels. Let's hope they stick to that one goal and forget trying to solve all of the world's other problems.