



Fed Strategy: Clench Your Teeth and Sit Tight!

Ben Bernanke is supposed to be a serious baseball fan so he knows what the Dog Days of August are all about. That's when the humidity and the gnats and the injuries all pile up. It's when a contender hunkers down, just trying to steam into September healthy and hungry and ready for a successful stretch drive. The real pennant races are decided in September, but to get there, you have to suffer the Dog Days of August.

Apparently the Fed has a similar calendar in mind, because it is now clenching its teeth and sitting tight after 17 straight moves over two years, 25 bps at a time! It recognizes the two themes between which its policy is hammered out: slowing economic growth or rising inflation. It can't be sure which one is a sucker's pitch!

Take the inflation news. Not too good, with **yo**y core inflation rates well above the 2% marker and some evidence that the inflation numbers will get worse before they get better. Today, more evidence on that front with unit labor costs showing a more rapid upward course and likelihood that they will continue to rise before the inflation scare dims. Fortunately, productivity numbers still show some firmness, which tends to limit unit labor cost rises, but the data cannot just be ignored.

What about slowing economic growth? Last week's jobs report continued the recent trend that shows job creation in the 110/120 thousand range, well below the supposed 150 thousand that it takes to keep unemployment from rising. The measured unemployment rate rose 0.2% to 4.8%. The real issue for Fed policy makers is which trend will dominate as we move into September and October.

To muddy the waters just a bit more, pipeline troubles on the Alaskan North Slope will shut in some 400,000 barrels a day or more just when geopolitical troubles threaten to elevate upside crude oil risks once again. Since the energy price pass-through already concerns the Fed, this will provide even more to ponder as they work their way to the next meeting on September 20, 2006.

Clearly one can make a case for worry and for the first time during the Bernanke era, a dissenting vote was made public. Jeffrey Lacker, President of the Richmond Fed, voted for another increase of 25 basis points. This is probably not the last time in this cycle's course that dissent will emerge. It should, because the Fed's call, while widely expected, is still a gamble. The gamble is that the 17 prior hikes plus the significant increase in energy costs will dampen spending sufficiently, particularly when added to the peaking of the housing cycle to allow inflation to wither away. Some will argue that taking your foot off the brake before the inflation threat is resolved only increases the likelihood of a more vigorous anti-inflation campaign later this year. September and October will tell the Fed much more about which scenario will play. It was a manager's call!

Given the call and the expressed dissent, the next period of Fed speak will delineate the argument within the Committee more clearly. The inconsistency of worrying about inflation and not raising rates will work its way through the markets and in our view it is likely that the implied probability of a further increase in the Funds rate in September will rise. When you lay yourself open to letting the data do the talking, you have to hope the message in the data will be clear. Here's hoping!