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STEERING IN A DENSE FOG

"The long lags in the operation of monetary policy make it very difficult to use this policy instrument with precision. Because of these long lags, the FOMC can't base its decisions on current levels of output and inflation alone. Instead, it must try to forecast what the economy will be doing six months to two years in the future — and make policy based on these forecasts. Because economic forecasts are often inaccurate, monetary policymaking has sometimes been likened to trying to steer a ship in a dense fog."

From Macroeconomics

By Andrew B. Abel and Ben S. Bernanke, 2005

Increased uncertainty about the future course of global economic growth, inflation and monetary policies has roiled financial and commodity markets. Investors have been fleeing riskier assets, particularly equities and commodities.

The primary cause of this behavior is the growing recognition that the certainty created by a long period of easy money is ending, and the liquidity-driven gains of the past few years no longer will be supported by the world's central banks. Bolstering this recognition, central banks around the globe — including those in the euro region, India, South Africa, Turkey, South Korea and Thailand — have recently increased interest rates. This appears to be the first synchronized tightening in global rates in more than five years.

The Federal Reserve is in the middle of this unfolding scenario. For the past two years, the Fed has been tightening policy in a measured and predictable fashion. This is now changing. The Fed, under the leadership of its new chairman, Ben Bernanke, is in the process of deciding when enough monetary tightening is enough.

As suggested by our introductory quote from the textbook *Macroeconomics* (co-authored by Bernanke and Andrew B. Abel), this is never an easy decision. At this moment, the decision is particularly difficult because the U.S. economy appears to be in a period of slowing growth and rising inflation. A premature end to monetary tightening might allow unacceptable levels of inflation to take root in the system. Overtightening, or "overshooting," on the other hand, might seriously damage the economy and produce a recession.

The challenge of setting policy is compounded by the "long lags" between policy changes and their economic consequences. The effect on gross domestic product growth, for example, isn't fully felt until 16 or more months after the initial policy change. And price response is even slower. The problem in controlling inflation, in other words, is much greater because the lag from policy to prices is very long. This partially explains why St. Louis Fed President Bill Poole would say, "It's a lot easier, I think, to turn the growth process back on by bringing rates down than it is to reverse a persistent rise in inflation expectations."

Concern about inflation and rising inflation expectations currently dominate deliberations at the Fed. The risk of policy "overshooting," for example, received only brief mention at the May Federal Open Market Committee (FOMC) meeting. In contrast, because of incoming inflation data, the odds of further monetary tightening have recently increased, and futures markets are now pricing in the virtual certainty of another 25 basis point rise in the Fed Funds rate at the June FOMC meeting. An additional motive at play: The Fed's new leadership wants to clearly establish its anti-inflation credentials so that, if it wants to pause or even ease later, it can do so without concern that inflation expectations will immediately worsen.

Tightening global liquidity and growing uncertainty about future Fed policy occurred as equity markets entered the traditionally weak summer months. A run-up to midterm U.S. elections, moreover, often generates added volatility this time of year. The current correction in riskier asset markets, while disconcerting, isn't surprising given this background. Such corrections, particularly if accompanied by panic selling, can create great buying opportunities if underlying fundamentals remain strong.

And business fundamentals remain truly impressive. Corporate profitability reached record levels in the first quarter — profits as a share of national income rose to a postwar high of 8.86%. This performance, when combined with the accompanying generation of free cash flow, provides solid underlying support for equity markets. Corporations are entering this period of heightened uncertainty with remarkably strong balance sheets and with the growing wherewithal to invest in new projects, buy other businesses, pay higher dividends and undertake record stock buybacks.

Tactically, we recently recommended reducing risk in portfolios, anticipating market adjustment to the evolving economic and policy environment we have been describing. Strategically, however, we would maintain equity allocations near longer-term norms, as business performance remains excellent and valuations are increasingly compelling. The fog, as usual, eventually will lift.

Commentary provided by Orie L. Dudley, Jr.