

Fed Will Make Excuses About Inflation

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Inflation is tame. For now. The CPI (consumer price inflation) was flat in January and is up only 1.6% from a year ago. The PPI (producer prices) rose a small 0.2% in January and is up just 1.4% from a year ago.

And even though energy prices spiked in February, the year ago comparisons are likely to stay tame. The consensus expects the February CPI to rise 0.6% - the largest in 44 months. Nonetheless, it would still show just 1.9% inflation in the past year, which is still below the Federal Reserve's target of 2%.

This won't last. With the Fed loose; we expect consumer prices to rise toward 3% during 2013. Then rise to 4% in 2014 on its way to 5% gains, maybe even higher, in the next few years. In theory, the Fed has said that 6.5% unemployment and 2.5% or greater inflation would force it to tighten policy.

However, we believe the Fed will remain in denial about inflation. Ben Bernanke, Janet Yellen, and Bill Dudley – the power-elite – don't believe inflation can head higher, so when it does, they will either ignore it or blame it on temporary, one-off shocks as the Fed did in the 1970s.

The first excuse will be that higher inflation is due to commodities, and they are just not that large a part of the economy. Moreover, "core" inflation remains tame.

But when rising housing prices (and rents) push "core" inflation above the 2% target, the Fed will resort to its second excuse: housing prices are just bouncing back to normal...and that this is just a temporary phenomenon.

The third excuse will be that "it is not actual inflation that matters, but what the Fed forecasts future inflation will be" over

the next year or two. And, as long as the Fed is forecasting a return to 2% or lower, then there's nothing to worry about.

If we are right and inflation persists above 2% and continues to rise, that excuse won't work anymore, either.

Enter excuse number four: this is when the troika of Bernanke, Yellen and Dudley will argue that "it's OK for inflation to exceed a 2% target because it has to make up for when inflation averaged below target during past years."

Finally, the Fed will resort to excuse number five, which will blame increasing price pressures, not on loose money, but on things like temporary weakness in the dollar or a temporary increase in velocity or the money multiplier.

And to top it all off, many at the Fed will probably start arguing that inflation of 3-4% is good for the economy. It was OK in the 1980s when Volcker ran the Fed, so it should be acceptable today, especially with the real economy so fragile.

We've seen this movie before, and it didn't end pretty. Back in the 1970s, the Fed blamed higher inflation on OPEC, or a weak dollar, or union wage deals, anything but overly loose monetary policy. As a result, the Fed lulled itself to sleep and inflation eventually got totally out of control.

We hope that doesn't happen again. But, if we start hearing excuses, like those listed above, then the odds of sharply higher inflation will rise. So, let's check the excuses off the list one by one, and see. The more excuses, the higher inflation will eventually go and with it, bond yields as well.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
2-26 / 9:00 am	Consumer Confidence – Feb	62.0	62.8		58.6
9:00 am	New Home Sales - Jan	0.380 Mil	0.385 Mil		0.369 Mil
2-27 / 7:30 am	Durable Goods – Jan	-4.6%	-5.0%		+4.3%
7:30 am	Durable Goods (Ex-Trans) – Jan	+0.2%	+0.0%		+1.0%
2-28 / 7:30 am	Initial Claims – Feb 23	360K	362K		362K
7:30 am	Q4 GDP Second Report	0.5%	0.6%		-0.1%
7:30 am	Q4 GDP Chain Price Index	0.6%	0.6%		0.6%
8:45 am	Chicago PMI	54.1	53.9		55.6
3-1 / 7:30 am	Personal Income – Jan	-2.4%	-1.9%		+2.6%
7:30 am	Personal Spending – Jan	+0.2%	+0.2%		+0.2%
8:55 am	U. Mich Consumer Sentiment- Feb	76.3	76.5		76.3
9:00 am	ISM Index – Feb	52.5	52.3		53.1
9:00 am	Construction Spending - Jan	+0.4%	+0.9%		+0.9%
Afternoon	Domestic Car/Truck Sales - Feb	12.0 Mil	12.1 Mil		12.1 Mil