



## MCAG MACRO: IMPLIED INFLATION

**A**lthough it's not necessarily the case that the Fed will unleash some more QE on the economy, the markets took the minutes as confirmation of what it factored in three weeks ago after the last meeting. But what we can't forget that the meeting *was* three weeks ago and the next meeting is three weeks away. A lot can change between now and then. The behavior of investors in anticipation of QE and its predicted effects, or in the presence of or absence of fear of deflation is important here. What's also important to look at is what is factored in, especially to bonds, and how that sways the effectiveness of a move by the Fed if there is to be one.

Market sensitivity has narrowed to rely heavily on policy expectations for cues and the Fed has market psychology on its side, but it could just as easily be against it. Contradictory is the focus of the Fed to be pushing inflation higher if their goal is to push rates down by buying Treasuries. I've heard this choice of words and resulting dip in bonds called a head-fake by the Fed to ensure the effectiveness when they do announce.

In the his column yesterday, **QE2 Will Have to Encourage Risk Taking** (<http://www.ft.com/cms/s/0/e6f4072a-d55f-11df-8e86-00144feabdc0.html>), James Mackintosh talks about the self-fulfilling market prophesy that the Fed is arguably creating; "across the board, markets are pricing in a return almost all the way back to normal inflation. In one way, this is self-fulfilling: take away fears of deflation and the changes in behaviour that follow make deflation less likely. Equally, higher commodity prices resulting from QE2's expected debasement of the dollar create inflation." Are they actually trying to create inflation or just turn our heads away from the dangers of factoring in deflation?

More QE, a weaker dollar, and looser policy were all ammunition used to take aim in China's defense of its own monetary policy this weekend at the IMF meeting. Unfortunately, the firm and highly vocal counter-argument set the tone for the meeting and thus it concluded without any sort of resolution.

More unfortunate is that both arguments are right; manipulated exchange rates stand in the way of global recovery and, super-loose monetary policy in the advanced world creates destabilizing capital flows for the emerging companies. As well, the guilt lies with both sides, but neither is willing to budge. A new money flood resulting from QE2 will cause dollars to be injected into countries whose debt has a worthwhile yield, thus exacerbating the problem less developed countries have.

I'm not saying that based on policymakers' judgment of the rate of improvement in our economy that QE2 is or isn't warranted but I do wonder if we're ready to handle to the side-effects and the consequences if it backfires, i.e. if China starts selling our debt from its balance sheet, or if our own inflation rate starts on a scream higher. On Friday, Bernanke is speaking at the Boston Fed's Conference on "Revisiting Monetary Policy in a Low-Inflation Environment." It will be an opportunity for Ben to offer up some clarity.

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