

DAILY GLOBAL
COMMENTARY

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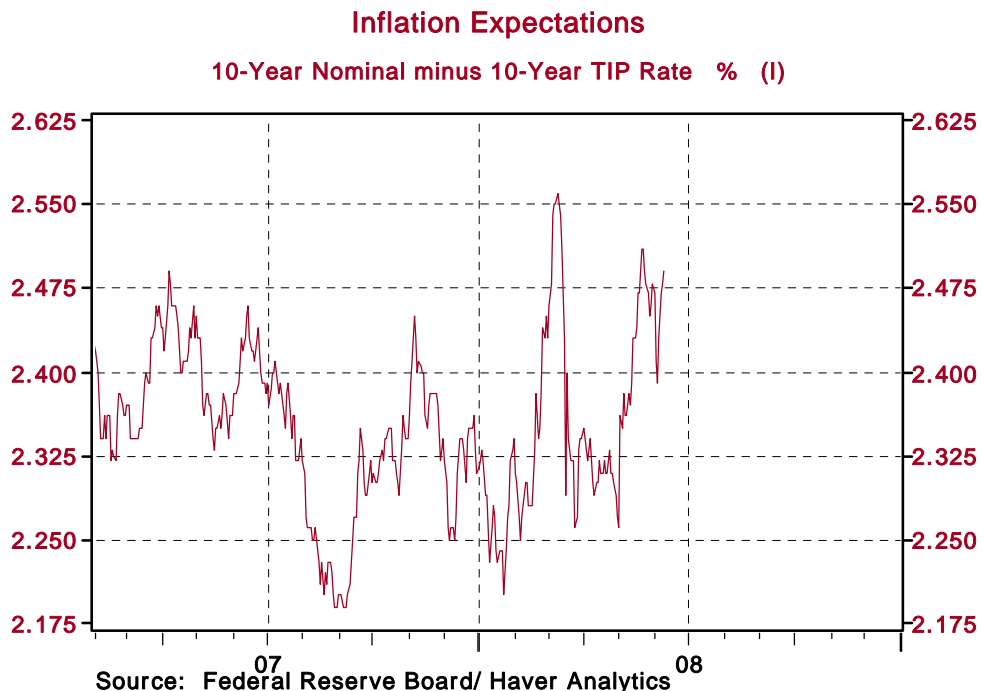
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Inflation Expectations, Market Forecast of Federal Funds Rate, and History

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Inflation and inflation expectations have a prominent spot in recent rhetoric of Chairman Bernanke and other officials of the Fed. The Fed has constantly stressed the importance of “well anchored inflation expectations.” Despite the tough talk about inflation and inflation expectations in recent days, the market estimate of inflation expectations, as measured by the difference between the nominal yield of 10-year U.S. Treasury note and 10-year TIP rate, has moved up from a recent low of 226 bps on May 1 to 249 bps on June 10 (see chart 1).

Chart 1



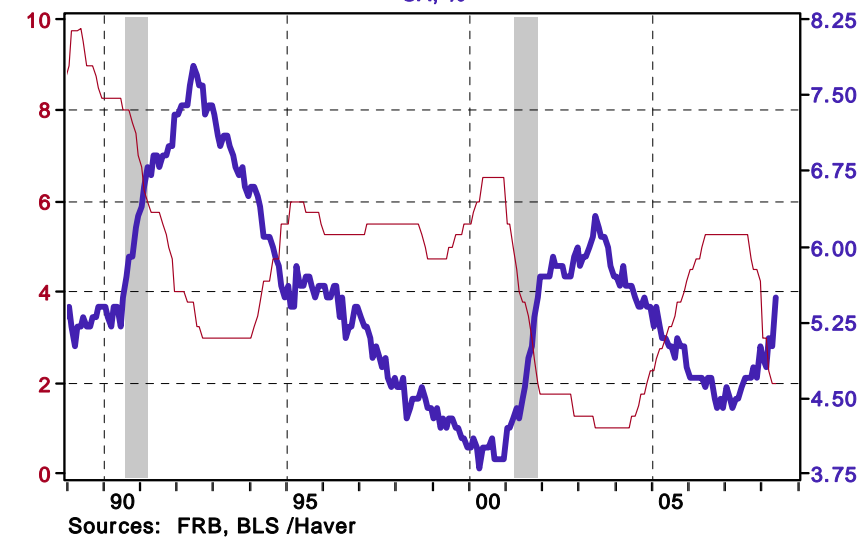
As mentioned in earlier commentaries, the Fed is in a tight spot and cannot raise interest rates to contain inflation and support the dollar. But, the federal funds futures market is projecting a higher federal funds rate. The November federal funds futures contract projects a 50 bps increase in the federal funds rate (see chart 2). The January federal funds futures contract implies a 2.75% federal funds rate. There has been a rapid change in expectations in the last week with the November contract implying a 2.50% federal funds rate today from 2.085% on June 3, when Bernanke presented the latest economic outlook and noted the concern about inflation and the dollar.

Chart 2
Implied Federal Funds Rate - November Fed Funds Futures Contract
 (I)



However, against the backdrop of weak economic data, this projection should be viewed with care because history fails to support this forecast. The Fed has not raised the federal funds rate until the unemployment rate has **declined** (see chart 3). The unemployment rate has not even peaked yet, so considerations of a higher federal funds rate by year-end appear far fetched.

Chart 3
 ← Federal Open Market Committee: Fed Funds Target Rate EOP, %
 Civilian Unemployment Rate: 16 yr + →
 SA, %



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