The Fed's worst nightmare

Ugly retail sales and a somber forecast from CFOs point to recession, but rising oil and gold prices and a weak dollar show inflation. What's Ben Bernanke to do?

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NEW YORK (CNNMoney.com) -- It's days like today that will make many investors wish they stayed in bed.

And they're not the only ones. Something tells me that Ben Bernanke and the rest of the Federal Reserve's policy-making committee would like to run and hide as well.

Where to begin? Retail sales for February were shockingly weak, with sales falling 0.6% during the month compared to economists' forecasts of a 0.2% gain. Those numbers put dents in the argument that consumers would keep spending in the face of the housing downturn.

Wall Street is also digesting some sobering results from a survey of chief financial officers released by Duke University and *CFO* magazine late Wednesday.

According to the survey of more than 1,000 CFOs, conducted last week, three-quarters of the respondents said the economy is either in a recession already or will hit one this year, and nearly 90% of CFOs surveyed said they didn't think the economy would rebound until late 2009.

So this means the Fed should slash interest rates at its next meeting on March 18, right? After all, according to federal funds futures, investors are pricing in a 72% chance of a three-quarters of a percentage point cut.

But not so fast.

Gold hit $1,000 an ounce for the first time ever Thursday morning. Oil is slouching towards $111 a barrel. And the dollar hit a 12-year low against the yen and a new record low against the euro. Can you say inflation?

Actually, it's worse than mere inflation. The combination of rising commodity prices and the weakening growth forecast for the economy has people worried about 1970s style stagflation. I hope Bernanke can dig up a pair of old bell bottom pants. Do the hustle!

"Clearly, the Fed needs to switch to Plan B," noted Duke professor Campbell R. Harvey in a release about the CFO survey.

But what is Plan B exactly? It's difficult to figure out just what the Fed can do other than let the credit markets and housing markets work themselves out, and hope the actions the central bank has already taken stimulate the economy at some point.

Time may be the Fed's only ally

Even though the Fed's series of rate cuts since last September - as well as the hundreds of billions in cash and Treasurys that the central bank has pledged to loan capital-constrained financial institutions - have failed to encourage more lending just yet, investors and consumers need to realize there is a lag effect of several months before Fed policy moves have an impact. History shows that Fed easing will eventually work their magic.

Hopefully, the rate cuts will encourage more banks to loosen their lending standards again, and will spur consumers and corporations to start spending more by the end of 2008 or early 2009.

Plus, even though there is a debate about whether the tax rebate checks that consumers will receive in the next few months will really help the economy that much, it's hard to see how the rebates can hurt.

But as I've said earlier this week in this column and numerous times before that, the Fed cannot drop the ball on inflation even if there are more signs of severe economic weakness. On Friday morning, we'll find out how much consumer prices rose in February.

Economists are predicting a 0.3% rise in the headline Consumer Price Index (CPI) number and a 0.2% increase in the so-called core number, which excludes volatile food and energy costs.

If the CPI figures are higher than expected, the Fed may have no choice but to disappoint Wall Street next week and only cut interest rates by a half-point, or perhaps even only by a quarter-point.

A quick fix for the economy is not what's needed. The Fed has to ensure that its actions don't lead to the type of double-dip, or W-shaped recession, that some economists and market strategists are now talking about.

Harvey indicated this could be the longest slowdown since the double-dip of 1979 to 1981. But if the Fed holds firm and doesn't stoke even greater inflation by lowering its key federal funds rate that much further, perhaps there's a chance this slowdown will turn into, at worst, just your garden-variety recession - and not an unwelcome rerun of what happened in the 1970s.

What do you think? Will more rate cuts help get the economy back on track or should the Fed focus more on inflation?

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