TrendMacrolytics

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FED SHADOW

One Wild Ride

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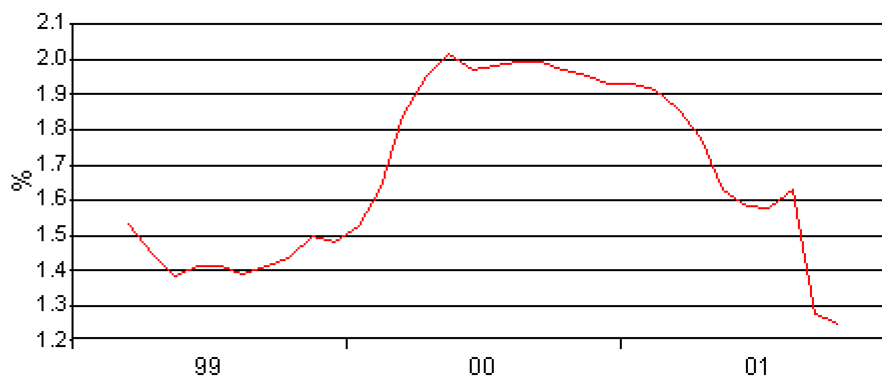
Friday's neck-snapping session for Treasuries, with long-maturity issues initially rallying on weaker-than-expected employment data only to set off within minutes on a hair-raising, two-point plunge, underscores the intense uncertainty now at large in U.S. financial markets. The roller coaster ride of the long bond the past several weeks has mostly mirrored the volatility at the short end of the yield curve and in out-month interest rate futures. But at yield approaching 5.6%, up 40 bps just since last Tuesday's close and some 80 bps above its lowest levels last month, the 30-year Treasury is now discounting for an economic resurgence, and consequent reversal of **Fed** policy, that tests the upper bounds of plausible outcomes. Given the still-extant climate of monetary deflation, and what we see as reluctance at the Fed to move quickly against a nascent economic rebound that might (but has yet to) develop, upside potential at the long end of the curve would appear to dwarf any remaining downside risks.

The bifurcation of the current expectations environment is striking. Interest rate futures are now fully priced for a funds rate cut to 1.75% at tomorrow's **FOMC** meeting, an expectation actually strengthened Friday by the unexpected surge in unemployment to 5.7%. But after holding steady through the first quarter of '02, euro-dollar futures now see funds beginning an upward march that will add some 200 bps to the overnight rate by the end of next year and 275 bps by early 2003. Even accepting that the Fed's dominant Phillips Curve mentality sees inflation as the natural consequence of any growth uptick, and rate hikes as the required response, that seems quite a stretch. **Greenspan** & Company, for one thing, might be considerably less inclined to hike rates in the face of what is likely to be a continued decline in reported inflation. As it is, on a three-month moving average basis, the core personal consumption deflator is now rising at a rate of about 1.2% year-on-year, down from about 2% a year ago. Given the continued deflationary readings in various forward-looking market-based price indicators, this trend is likely to continue. In fact, the core PCE deflator, the least distorted of the official price indexes and the Fed's reference indicator, could soon be registering annualized gains near or below zero.

Personal Consumption Expenditures Core Deflator
3 month moving average, 12-month percentage change



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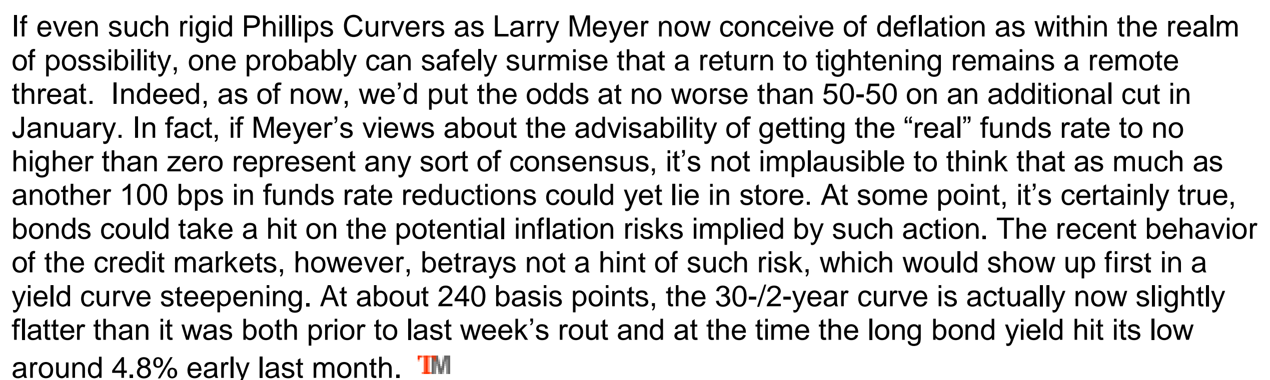
To be sure, that won't necessarily trump the Fed's proclivities toward macroeconomic fine-tuning in the name of pursuing a "preemptive" policy approach. But there is reason to think the monetary high priests could well take a somewhat more cautious approach in the next cyclical upswing. There is little doubt that the current recession is more than they bargained for when setting out in mid-1999 on a course that would ratchet up the funds rate by 175 bps over the following year. In that context, consider the curious example of **Laurence Meyer**, the Fed's quintessential Phillips Curver who was at the forefront in arguing for a forceful campaign of monetary restraint in 1999-2000. Although not quite an expression of regret, Meyer's recent speech emphasizing the latitude remaining for additional rate cuts was a notable departure. If there were anyone at the central bank whom one would expect to tilt toward a tighten-first approach coming out of this recession, it would be Meyer. After all, although the unemployment rate has soared by 1.8 percentage points in little more than a year, it still is just a notch above the level Meyer's archaic models posit as the mythical "natural rate," below which inflationary danger always lurks.

Instead, though, Meyer conceded that "financial conditions" had yet to improve in response to the Fed's cuts, and he rebutted contentions that the central bank ought to carefully husband the 200 basis points left to it for further potential rate reductions. He argued, quite the contrary, that the low level of the rate should incline the Fed toward more – rather than less – aggressive use of its remaining margin for action. To do otherwise, he suggested, would court the risk that an eventual decline of the nominal funds rate even to zero would still imply a positive real rate if, as in Japan, the current low level of inflation in the interim turns to deflation.



If even such rigid Phillips Curvers as Larry Meyer now conceive of deflation as within the realm of possibility, one probably can safely surmise that a return to tightening remains a remote threat. Indeed, as of now, we'd put the odds at no worse than 50-50 on an additional cut in January. In fact, if Meyer's views about the advisability of getting the "real" funds rate to no higher than zero represent any sort of consensus, it's not implausible to think that as much as another 100 bps in funds rate reductions could yet lie in store. At some point, it's certainly true, bonds could take a hit on the potential inflation risks implied by such action. The recent behavior of the credit markets, however, betrays not a hint of such risk, which would show up first in a yield curve steepening. At about 240 basis points, the 30-/2-year curve is actually now slightly flatter than it was both prior to last week's rout and at the time the long bond yield hit its low around 4.8% early last month. TM