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FED SHADOW

Recovery Buster

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Based on the expectations for **Fed** rate increases now priced into the bond and money markets, one would think the existing 1.75% funds rate is feeding an inflationary boom that the Fed will be duty-bound to act against in short order. The market-price signals that we monitor to gauge the strength of dollar purchasing power, however, show that while *deflation risks* have subsided, they betray not a trace of an *inflationary impulse*. Of course, this market response to early hints at economic recovery is not wholly irrational, given the Fed's recent track record acting to rein in non-inflationary growth in the name of "preempting" a rise in the general price level. But having devastated one of the most vibrant expansions in U.S. economic history with its most recent foray into policy activism in 1999-2000, our bet is that the Fed will be inclined to adopt a considerably more low-key stance in the early stages of whatever recovery is now aborning. Certainly, Eurodollar futures now priced for a 3.5% funds rate by year end and 4.5% by spring 2003 appear to represent a forecast beyond the bounds of plausible outcomes. They are among the compelling opportunities presented by credit market instruments now discounting for a worst-case policy outlook.

S&P Speculative Grade Credit Spread

It is only in the past week that we have begun to see preliminary indications that a turn in the deflation expectations environment is helping to restore a degree of risk preference so vital to regenerating a dynamic expansion climate. Most encouraging has been a long-awaited rally in the high-yield debt market, where spreads have narrowed by some 75 basis points since early last week, according to the S&P Speculative Grade Credit Index. At current levels just above 600 bps, junk spreads are now at their narrowest since summer 2000, after briefly spiking to nearly 1,000 bps in the early post-9/11 paralysis of the capital markets. It should be noted, though, that in isolation the recent tightening of spreads offers somewhat of an exaggerated view of the market's turn toward risk, coinciding as it has with the powerful sell-off in Treasuries. Since February 27, 10-year Treasury yields have soared by nearly 60 bps, while the junk spread has dropped a total of 107 bps. A non-trivial portion of the recent reduction of the credit-quality

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premium, then, can be explained by the back-up in zero credit-risk issues, not by the market's increased appetite for risk.

Still, the decline of the risk premium in speculative-grade debt provides about the most solid evidence yet that the recent easing of dollar deflation is beginning to foster a less risk-averse economic environment. For the marginal borrower, the softening of the unit of account -- if sustained -- could reduce the real burden of debt sufficiently to mean the difference between bankruptcy and solvency. Clearly, though, it's too soon to be declaring any victories in that regard. As can be seen in the accompanying chart, the past year was witness to several false starts in the high-yield market. By no means is it out of the question, given the current volatile market environment, that this could turn out to be another one.

In particular, an ill-conceived campaign by the Fed to chase down a non-existent inflation threat would no doubt cut the legs out from under any budding recovery in the market's tolerance for risk. Analysts and commentators across a wide spectrum of economic perspectives seem mesmerized by the current 1.75% funds rate, as if it represents an *ipso facto* threat to economic stability. The truth is that the absolute level of the overnight target rate is far less significant than its position relative to an expected market-wide rate of return. If the rate were set too low relative to that prospective rate of return, it would encourage a surge in borrowing and lending activity, forcing the Fed to inject liquidity at a rapid pace to maintain the target against a rising demand for reserves. As a rising excess of dollars circulated through the system, a decline in the currency's real purchasing power would show up first in an abrupt rise in sensitive commodity prices and a sharp decline in the currency's foreign exchange value.

Is anything resembling such a phenomena currently detectable? Hardly. At this point, the most that can be said is that the Fed's open market stance has finally moved to relieve a deflationary shortfall of liquidity that had seen the one-year moving average price of gold drop from $330 in early 1998 to below $270 last summer. Over the same period, the G-6 trade-weighted dollar index rose from 100 to a 15-year high of 120, which is also where it stood as recently as late January. In a range around $290 per ounce, the dollar gold price is up less than 10% from the low- to mid-$270 ranges that held over most of the last year. The G-6 dollar, meanwhile, is just 2.5% below its recent highs. It's a similar story for the broader commodity indexes. The CRB Spot index, for example, has finally crawled back to levels last seen prior to 9/11. Today's producer price index, at the same time, captured some of the lingering deflationary influences that are still working through the price system, with prices for crude goods down 0.8%. A building excess of dollar liquidity is certainly not visible in recent Fed data, meanwhile, which shows reserve growth over the past two months running at an annualized rate of less than 7%. That's actually a significant deceleration from the 35% annualized two-month pace recorded as of late February. TM