TrendMacrolytics

Donald Luskin, Chief Investment Officer
David Gitlitz, Chief Economist

FED SHADOW

FOMC Preview

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David Gitlitz

With virtually no chance of a change in its overnight rate target, speculation surrounding tomorrow's **FOMC** meeting centers on whether policy makers will adopt a "neutral" bias in their post-meeting announcement, shifting from a predominant concern with economic weakness in its "balance of risks" statement. The Wall Street consensus sees a bias shift tomorrow as the first step in a process that will have **the Fed** raising rates at its next meeting in early May and remaining in a rate-hiking mode until the funds rate is brought all the way back to 4.75% by mid-2003. For those who may not recall, that is where the overnight rate stood in mid-1999 prior to the six misguided hikes over the following year that brought the rate to 6.5%, which precipitated the economic slide that led to the 11 rate cuts last year.

Our view is that a shift to neutral tomorrow is no more than a 50/50 proposition. If the FOMC maintains the existing bias toward weakness, the structure of the forward yield curve is likely to undergo a major alteration, presenting opportunities for significant gains in out-month Eurodollar contracts now priced for a spree of Fed tightening nearly as aggressive as last year's rate-cutting. Actually, we assign such a low probability to the aggressive-tightening scenario, we see significant upside as likely to be captured across a range of credit market instruments even in the event of a bias shift, but not as quickly.

These post-meeting FOMC statements are all about managing expectations, and right now the Fed is walking a fine line. On the one hand, it is comfortable encouraging the view that the downturn is likely over, at least to the extent that lean inventories are setting the stage for a necessary spurt in production in order to satisfy current demand. That would probably argue for a neutral stance. Fact is, though, it remains highly chary about the longer-run outlook, and is likely to exercise considerable caution before initiating any reversal of the rate cuts lest it jeopardize a recovery that remains highly fragile. Bear in mind, as we noted Friday, there remains not the slightest hint of an inflation threat in any indicator of the dollar's relative strength (see “Recovery Busters” March 15, 2002).

One week after telling **the Senate** that "an economic expansion is already well underway" (which followed by just a week his **House** testimony suggesting only that cyclical forces were "prompting a firming in economic activity"), **Alan Greenspan** last week reverted to an emphasis on uncertainty in the current environment. Gone from his speech to the **Independent Community Bankers** was talk about an "expansion... well underway." Instead, his remarks were sprinkled with references to "tentative indications" that the economic contraction is over, and to "ample reasons to be cautious" about the outlook. All in all, then, whether tomorrow's meeting yields a move away from the predominant concern with economic weakness seems like a tossup. In any case, though, the market's discounting for a quick opening of a prolonged rate-hike campaign appears to be far ahead of the Fed's own inclination to act. We're anticipating that the Fed will, one way or another, look for ways to bring those expectations into better alignment with its own perceptions of reality. TM

http://www.trendmacro.com
don@trendmacro.com
dgitlitz@trendmacro.com

325M Sharon Park Drive #325
Menlo Park CA 94025
Phone 650 429 2112
Fax 650 429 2112

42 Forest Drive
Parsippany NJ 07054
Phone 973 335 5079
Fax 973 335 8016