TrendMacrolytics

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FED SHADOW

Not So Fast

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For the Fed, reversing last year's rate cuts looks likely to stay on hold.

We began telling clients late last year, when super-V recovery fever first took hold, that expectations for **the Fed** entering upon an early and aggressive rollback of the 475 basis points in Fed funds rate cuts effected in 2001 were vastly overdone. We said **Greenspan** and friends, chastened by the economic downdraft for which they were largely responsible, were likely to take a cautious stance in the early stages of this expansion. Even if the Fed remained committed to its flawed macroeconomic fine-tuning paradigm, the recovery likely to materialize gave no hint of being strong enough to justify more than 200 bps in rate hikes by the end of this year and 300 bps by next year's first quarter.

That analysis has held up well, and the past few months have seen a significant down shift in the forward rate curve discounted in the Eurodollar futures market. The December 02 contract is now pricing an overnight rate less than 100 bps higher than the current 1.75%, while March 03 shows an increase of about150 bps. The upside in these bets on the Fed's near- to mid-term course may appear less compelling than it did in late March when we established a Model Position long the December Eurodollar contract. But the arrival of the Fed's initial rate hike looks likely to continue to be pushed back. That was reinforced by the still-guarded mood Greenspan displayed last week, when he maintained that capital spending is "is not going anywhere fast." We rate it as a toss-up whether the Fed makes even one rate hike this year.

The response to Friday's employment report was also instructive in that regard. While super-V diehards in the pundit community did their best to spin the May jobs data as positive news, the more mundane reality of a slow, gradual climb out of the economic doldrums is becoming inescapable. The reported gain of 41,000 payroll positions came in about 25,000 jobs short of consensus expectations, but confidence even in *that* disappointing figure must be considered suspect. Once again, the most telling part of the report was found in revisions to the previous month's data where, in a pattern that has become increasingly common, the initially reported increase of 43,000 in April payrolls was reduced to 6,000. So despite the payroll gain and an unexpected 0.2% decline in the unemployment rate to 5.8%, expectations for early Fed action continued to recede. The market now places an odds-on bet for the first rate hike to come at the September **FOMC** meeting (just as earlier it was for May, then June, then August). We'd be surprised if the initial hike were not put off until November at the earliest, and see no reason at this point to believe that such action would necessarily presage a quick succession of moves.

While that offers some comfort that at least a return to a deflationary stance is unlikely soon, we do not view the current policy environment as being without risk. Employment and other variables in the Fed's fine-tuning arsenal are lagging indicators of real economic activity and highly flawed as policy guideposts. As it has so often in its history, the Fed is now conducting policy to correct an error inspired by an earlier misguided conceptualization of its function, when it used a generational low in unemployment to rationalize a deflationary course. On these occasions, the risk of the Fed committing the opposite-but-equally-damaging error -- this one inflationary -- cannot be easily ignored. That may help explain why, even as short-run tightening risks actually fell slightly Friday, yields at the long end of the Treasury curve rose by as much as nine basis points.

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