Donald Luskin, Chief Investment Officer
David Gitlitz, Chief Economist

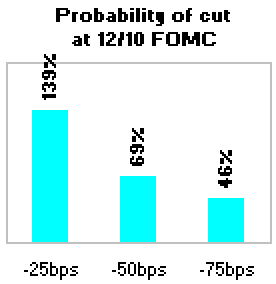
FED SHADOW

FOMC Blues

Monday, August 12, 2002

David Gitlitz

The same Wall Street economists who expected the Fed to tighten last spring are going to be disappointed all over again -- when the Fed doesn't ease.



Tomorrow's **FOMC** meeting will likely bring a dose of cold reality to those betting that policy makers will be anxious to confirm the market's bet that a new round of rate cutting lies in store. Despite reports in Friday's *Wall Street Journal* and *Washington Post* pouring cold water on any notion of an easing in the central bank's overnight target rate come Tuesday, August fed funds futures continue to price for a 25% chance of a 25 basis-point cut. Although the equity market rally unwound some of the more exuberant expectations priced into the fed funds futures curve earlier last week, the December contract at the close Friday was still priced for a 70% chance of a 50 bp rate reduction by year end. While we don't rule it out entirely, even as much as one 25 bp cut in the 1.75% funds rate this year seems like a stretch as of this writing. On that basis, the December 2002 fed funds futures contract appears to present an attractive short-selling target, one of the more appealing investment opportunities arising from this turbulent expectations environment.

It strikes us as being of more than passing interest that many of the pundits and analysts now leading the charge for lower rates only a few months ago were certain -- consistent with their V-shaped recovery calls -- that **the Fed** would be aggressively moving rates higher by now. Last week we suggested that much of the concern now surfacing about the risk of a double-dip recession reflected disappointment over the failure of the recovery to pan out nearly as strongly as many had hoped -- and had forecasted (see "Muddling Through" August 6, 2002). In the same way, this abrupt shift in policy expectations from Fed tightening to Fed easing is being led by a group of economic seers at Wall Street houses eager to get out from under the their earlier misjudgments. In March, for example, **Morgan Stanley's Richard Berner** was forecasting a doubling of the funds by the end of this year. On Friday, he was out with a call for a 50 bp cut at tomorrow's meeting.

For our purposes, it is highly debatable whether another rate cut or two would be either an effective or appropriate policy response at present. Short-run manipulation of the funds rate target within such narrow ranges can often have unintended consequences. As a first-order effect, a reduction in the overnight rate reduces the opportunity cost of holding liquid cash balances, thereby increasing demand for money. Under the Fed's clumsy rate-pegging mechanisms, the increased demand may not be immediately accommodated with more ample liquidity injections, thereby actually *tightening* liquidity availability, at least initially. With the dollar price of gold having rebounded by nearly $20 after briefly dropping below $300 per ounce early this month, moreover, the need for the Fed to signal a more generous liquidity stance is by no means clear cut. We'd be happy to see the gold price rise above $320, but would not be entirely content at the sight of the Fed appearing to rush into the monetary breach at this point. In terms of broad sentiment, it also is not at all clear why a Fed move at this point, indicating the economy is actually in worse shape than it has acknowledged up to this point, would necessarily bolster rather than dampen confidence.

But be that as it may, it's probably safe to assume that **Greenspan** & Company are considerably less inclined to sanction further rate reductions than some Wall Street economists would like. For one thing, the Fed's characterizations of the economy this year have been notable mostly for their tone of caution. While the central bank has pointed to a swing in the inventory cycle as likely to spur a brief growth spurt, it has consistently cited significant uncertainty about the outlook for strengthening "final demand," particularly with regard to capital spending. Since the Fed didn't envision a rip-roaring economic take-off in the first place, it is unlikely to be nearly as panicked as are many private forecasters by the slow pace of growth. With the funds rate already at 40-year lows, that would tend to augur for the Fed holding its fire unless and until the data clearly shows significant additional weakness. As well, Greenspan has staked no small measure of his credibility on the proposition that the Fed moved aggressively to cut rates last year to avoid a protracted recession. Having to cut rates further would be taken as tacit acknowledgement that he didn't do enough the first time, a step he would want to avoid unless it becomes clearly necessary.

Of course, the statement issued by the FOMC at the conclusion of tomorrow's meeting will be pivotal for the hints it drop about the course of policy going forward. Those pinning their hopes on a lower funds rate within the next few months are looking for some confirmation in the "balance of risks" assessment moving back to a concern with future weakness. We would be surprised, though, to see anything other than a largely status quo announcement, maintaining a neutral risk outlook. To do otherwise would be seen as a signal that the Fed is prepared to cut rates at the September meeting, a signal Greenspan is probably still loath to send at this point.

Most likely, that will register as a significant disappointment for those long the rate-cut bet, with the short end of the Treasury yield curve selling off in concert with futures contracts expiring before year-end. But further out on the curve, today's expectations are not so much about easing as about less tightening. Since early July, the June 2004 Eurodollar contract has rallied by more than 100 basis points, essentially rolling back the bet on the extent of Fed rate hikes from about 300 bps to less than 200. Those gains, reflecting belated recognition of the reality of a substantially slower recovery outlook, have also provided critical support to longer maturities on the Treasury yield curve. Trading in the latter part of last week offered a glimpse into this dynamic as the two-year note sold off by some 10 bps in keeping with the moderation of near-term easing expectations. The long bond, however, continued a powerful rally that -- at 5.11% -- has seen more than 40 bp taken off the yield since early last month, led by the continued erosion of rate-hiking expectations more than a year hence.

We have established a new three-part Model Position to take advantage of this trading environment. The first part shorts the December 2002 fed funds futures contract to capture the unwinding of what appears to be an extravagant bet on the probability and extent of Fed rate cuts this year. The second part shorts the September 2002 fed funds contract for the same reasons -- but, in addition, this contract month appears to be mis-priced relative to the other months, reflecting an unlikely inter-meeting rate cut. The third part shorts 2-year Treasury bonds against long 30-year Treasury bonds on a duration-weighted basis, recognizing that longer-term Treasuries should, at the least, be considerably less vulnerable to reversal than issues at the short end that have ramped up on rate-cut expectations. Details of the new Model Position will be available on our web site by the end of the day, and will be updated daily.