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FED SHADOW

The Reality Trade

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The FOMC's bias shift offers little support to a market over-extended on rate-cut expectations.

When a wholly lackluster reading on consumer sentiment provides the rationale for the kind of sell-off that hit the credit markets Friday, it's a good indication that the market had become significantly over-extended on hopes for a fresh round of **Fed** rate cuts. As we noted prior to last Tuesday's **FOMC** meeting, those hopes appeared vulnerable to a reconciliation with the reality that the Fed's current economic view is fairly sanguine, at least compared to the double-dip fears that had been driving market expectations (see "FOMC Blues" August 12, 2002). As a result, the immediate post-meeting bet in the fed funds futures pits for an odds-on chance of year-end rate cuts of 50 basis points has since dissipated to a solid chance of just one 25 bp reduction.

On the face of it, this might seem somewhat surprising since the FOMC ostensibly agreed in its statement Tuesday that the risks are now pointed toward "weakness." In a *Trend Macro Live!* note following the meeting, though, I pointed out that the committee's announcement seemed designed to restrain expectations of follow-up action. The lack of urgency in the policy panel's outlook was pretty obviously signaled with the observation that the Fed's current "accommodative" stance should prove "sufficient" to support recovery. Clearly, the central bank has yet to be persuaded that conditions are ripe for a lowering of the overnight rate.

In fact, from our perspective, whether the funds rate is held at 1.75% or reduced to 1.5% -- or even 1.25% -- is less important than the effect that the uncertainty over possible changes could have on borrowing activity. By opening the door to a possible cut, the Fed is also inviting marginal borrowers to delay their commitment to undertaking new activity. In addition to potentially further slowing the already slow pace of real economic expansion, the uncertainty could also have an adverse impact on the Fed's pace of liquidity additions. Under the Fed's rate-pegging mechanism, the provision of liquidity is keyed to reserve demand. To the extent that new borrowing and lending activity is suppressed by the possibility of lower rates to come, it also will tend to dampen reserve demand, resulting in a more restrictive open market stance. It's not out of the question that at some point the Fed could be compelled by its procedural rigidities to drain liquidity in order to keep the funds rate from falling below target. With the price of gold already exhibiting considerable resistance to sustaining a level above $310, and the dollar again showing a tendency toward strength against foreign exchange, the risk of another episode of deflationary dollar scarcity cannot be overlooked.

Meanwhile, the extreme volatility seen in Friday's rout brought with it an abrupt but likely temporary reversal of the recent yield-curve flattening. With the long bond selling off by two points, the yield jumping from 4.98% to 5.09%, the curve popped out to 284 bps after flattening by more than 20 bps to 279 bps in the four previous sessions. Our view, though, is that the short

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end remains considerably more vulnerable to reversal of Fed expectations, and our Treasury yield curve flattening Model Position likely has significantly more room to run. TM