

FED SHADOW

## FOMC Preview

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**Tomorrow's meeting should bring early hints of a forthcoming policy change.**

Chances are about nil that the **FOMC** tomorrow will change its 1% overnight rate target, but that doesn't mean the panel's announcement will be any less closely scrutinized. In the wake of the credit market wipe-out precipitated in part by an abrupt shift in **Fed** expectations following the late-June meeting that put the funds rate at new 45-year lows, badly burned market players are still hoping against hope that the Fed somehow will toss them a lifeline. We view that as highly improbable. Rather than hinting at the possibility of further ease, or even assuring that they will remain "on hold" as far as the eye can see, policymakers are more likely to gently begin prepping the market for the first steps rolling back a chunk of the 30-month, 550-basis-point rate-cutting cycle.

**G-6 Trade-Weighted Dollar Index**



For the most part, that is as it should be. The reversal in Treasuries marks a return to more normal levels from an excessive depression in yields fostered by a spooked central bank that managed to convince the market deflation was a real threat. In reality, the dollar's reflation against sensitive market price indicators confirmed that by the time deflation showed up on the Fed's screen, it

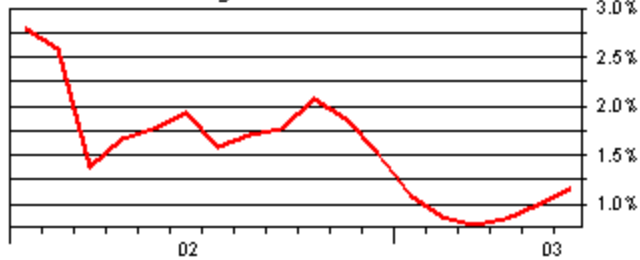
was yesterday's news. Consider the anomaly that at the peak of the bond rally, June 13, with the 10-year Treasury yielding 3.11%, the G-6 trade-weighted index showed the dollar at its lowest point against the other major currencies since late 1998, down nearly 25% from its levels early last year. A 1% funds rate against a reflatd dollar is no less anomalous. If putting the rate target at this level was an extraordinary step meant to guard against the risk -- however remote -- of a deflationary episode, that risk convincingly has been neutralized.

From the Fed's demand-management perspective, it would take a denial of the obvious -- that the economy is in the midst of significant acceleration -- to sustain the rationale for keeping rates at these levels much longer. Recall that in his July 15 testimony that so roiled the market, **Alan Greenspan** told the **House Banking Committee** that the Fed was "prepared to maintain a highly accommodative stance of policy for *as long as needed to promote satisfactory economic performance*. [emphasis added]" Barring a sudden, and unlikely, reversal in the pace of the economy's pick-up, the accumulating evidence certainly suggests that by that standard, the Fed's current posture will become increasingly difficult to justify.

In addition, while the last two FOMC statements highlighted the panel's concern about the possibility of an "unwelcome substantial fall in inflation," that risk appears to be waning. Since March, the PCE core deflator, the Fed's favored measure of statistical inflation, has gone from rising just 0.78% at a three-month annualized rate to more than 1.15%. Accounting for the lags

### Personal Consumption Expenditures Deflator

3-month rate of change at annual rate



in the deflator responding to the dollar's softening against foreign exchange, gold and broader commodity indexes over the past 18 months or so, a further stanching of the "disinflation" trend is practically assured.

That said, given the grief they're now taking for pulling the rug out from under an overstretched bond market, the central bankers will no doubt want to exercise

considerable care moving toward the inevitable rate-hiking exercise. At this point, the Fed's foreshadowing of an approaching change in course will likely be limited to some shift in phrasing toward a moderately more optimistic outlook. After tomorrow, the FOMC will still have three scheduled meetings before the end of the year. We would expect that the first tightening move will come no earlier than the December 9 meeting, and might well be put off until the first quarter of next year.

In betting on the timing of the Fed's policy shift, some striking investment opportunities have arisen. For example, December fed funds futures now carry an implied yield of 1.02%, pricing strong odds that the Fed will remain on hold at least through year end. Taking the short side of that bet, however, presents a highly compelling risk/reward tradeoff. For 2 basis points of risk (assuming one rules out the possibility of future rate cuts), one can play for 15 basis points of potential upside -- or 33 bps if the Fed moves by 50 bp on its initial hike, as many expect. (Fed funds futures settle at the contract month's average yield, so if the Fed raises rate by 25 bp on December 9, the month's average will be 1.17%. If 50, the average will be 1.35%.) We are establishing a speculative **Model Position short the December funds contract** at today's close. **IM**