TrendMacrolytics

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FED SHADOW

Betting on Sanity

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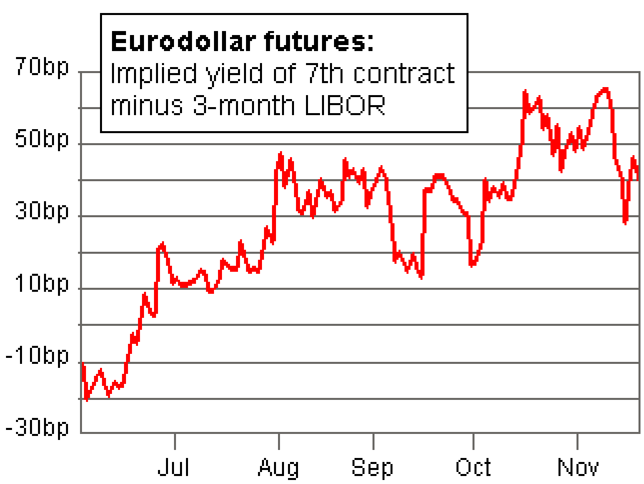
Markets think that the Fed isn't going to be quite as reckless as its rhetoric.

Last week we described how **the Fed** had launched a concerted campaign to counter any notion that it is contemplating a near-term shift in its exceptionally accommodative policy posture (see "See No Evil" November 14, 2003). To the contrary, an array of Fed speakers continue to insist that current policy remains appropriate to the task of extinguishing the risk of "unwelcome disinflation." By and large, the Fed effort has meshed well with accepted wisdom among the Wall Street economics fellowship, which holds that inflation is nowhere to be found, and the Fed thus has ample room to remain on its easy-money course.

In that light, we are intrigued by the behavior of the interest rate futures markets, the most direct, sensitive market indicators of Fed policy expectations. True, these market gauges are by no means an infallible guide to the ultimate disposition of policy, especially for out-month contracts. What they are is a reflection of the current consensus about future policy, which may or may not prove accurate. Early last year, for example, the Eurodollar and fed funds futures markets were priced for a series of rate hikes by year end in keeping with the consensus view that the economy was poised for a "V-shaped" breakout, compelling the Fed to raise rates sooner rather than later. Our analysis gave rise to substantial doubt about that consensus, and we established a **Model Position long December 2002 Eurodollar futures**, recording a profit of 399.7%.



Today's situation is different, however, in that the futures appear to be showing some resistance to the apparent consensus. Shaped by the recent outpouring of dovish rhetoric, that consensus now sees the Fed as unlikely to begin raising rates as early as next spring. Yet, April Eurodollar futures are currently priced for the near-certainty of a 25 basis point rate hike, and fed funds futures see the first move coming at the May meeting.

At the same time, June 2004 Eurodollars are currently discounting for an 80% chance of 50 bps in rate hikes, while the December contract is priced for more than 100 bps. To be sure, these instruments all posted significant rallies in response to delivery of the Fed's none-too-subtle message of recent weeks. The June contract, for example, went from discounting odds-on for 75 bps in rate hikes on better-than-expected jobs data, to barely pricing for 25 bps, all in the space of about a week (see the chart above).

What we find noteworthy, though, is that these markets have been unable to sustain these levels -- or, indeed, haven't surged even higher -- in the face of so much intensely dovish Fed-speak. That suggests to us that despite all the talk about output gaps, slack resources and the risk of falling inflation outweighing the risk of rising inflation, market participants charged most directly with placing their bets on the most probable policy course remain dubious.

Likely, it's no coincidence that rate-hike expectations backed up this week as gold breached the $400 plateau -- even if only briefly -- and the dollar fell to near seven-year lows against its major currency counterparts. And despite the still-prevalent mainstream view that "disinflation" risk remains the order of the day, those expectations -- on the margin at least -- no doubt reflect the reality that statistical measures of core inflation have already begun moving sharply higher over the past six months. Our best bet is that, going forward, that reality is likely to catch up even with our determinedly backward-looking central bank. Rate expectations, therefore, are more likely to move in a hawkish rather than dovish direction, and we reaffirm our **Model Position short the June 2004 Eurodollar contract**. TM