

FED SHADOW

FOMC Preview

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Greenspan won't take a pass tomorrow -- but that's where the certainty ends.

The real significance of tomorrow's **FOMC** meeting will be in the tone set for the policy outlook by the panel's post-meeting statement. Almost assuredly, there will be voices at the table counseling that a break in **the Fed's** "measured" rate-normalization process would be appropriate in the wake of the second consecutive month of disappointing payroll growth. Given this Fed's well-documented penchant for misguidedly viewing labor market data as a proxy for current monetary conditions, no doubt those advising adoption of an even slower than anticipated posture will get a sympathetic hearing in the Fed's cavernous conference room.

Nevertheless, it's a virtual certainty tomorrow's meeting will validate expectations and ratify a second consecutive 25 basis point rate hike, bringing the central bank's overnight rate target to a still unsustainably low 1.5%. For one thing, **Alan Greenspan** told **Congress** last month that the "softness" then being seen in the data was likely to prove "short lived," and he's not likely to want to disown that assertion by taking an unexpected pass on a rate-raising move after just three weeks. For the Fed to skip a move now would be widely interpreted as confirming the worst apprehensions about the economy's health, which Greenspan would be loath to sanction at this point. Also, Greenspan is not insensitive to skepticism about the Fed's credibility as it embarks on a self-professed campaign of gradual rate normalization against the backdrop of a policy stance regarded in certain quarters (here, for example) as significantly behind the curve. To suspend the process now on the strength of a jobs number that seems an outlier in the context of most current data would be a further blow to the Fed's -- and Greenspan's -- credibility.

However, with gold back up to \$400 after descending to \$385 in the wake of Greenspan's upbeat testimony last month, it's clear that the test of the Fed's credibility extends beyond confirming a near universally expected rate hike tomorrow. As it is, Friday's surprisingly weak payroll report essentially knocked 25 basis points off the expected year-end funds rate, from 2.25% to 2%. Futures that had been priced for 25 bp in higher rates emerging from each of the four remaining meetings now show about a 50/50 chance of hikes in September and November. Should the Fed in its post-meeting statement give substantial weight to the recent weakness in employment growth, we'd expect a further pricing out of rate-hike expectations, and a further weakening of the dollar as reflected in a rising price of gold. A dovish announcement tomorrow could well spark a gold rally that would see the monetary metal challenging the highs around \$430 seen in early April.

In the final analysis, though, the Fed's policy disposition will be driven by the data, and if -- as we expect -- this economic soft spot proves to be fleeting, another reversal in the expectations environment should be in store. Still, it's a good bet that even if the Fed doesn't fall as far behind the inflation curve as it otherwise might, nether is it likely to take sufficiently assertive tightening action before increases in reported inflation unavoidably force its hand.

That suggests that while bond buyers have had a field day amid the marking down of rate expectations, prospects beyond the short term do not appear nearly so bright. Even if the Fed affirms the bond market's hopes that rates will be raised more slowly than had been expected, in the long run bonds cannot remain immune to the inflation expectations implications. And when the Fed ultimately takes a turn toward more aggressive action, the market is hardly priced for the rate-hiking regime that would unfold over the next 12 to 18 months. We continue to see it as likely that some mix of both higher than expected inflation and a more aggressive than now expected Fed ultimately will combine to tank long-maturity bonds. **TM**