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FED SHADOW

Rude Awakening?

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At these yields, the bond market needs the FOMC to be a lot gloomier than it's likely to be.

A bond market priced for virtual economic stasis, and hoping for signs that **the Fed** largely concurs, could be in for a rude awakening following tomorrow's **FOMC** meeting. At a yield today of 4.05%, the 10-year Treasury is again challenging levels not seen since the surprisingly strong job market bounce-back early last spring shattered expectations that the Fed would remain in hyper-accommodative mode more or less indefinitely. Another 25 basis point move in the funds rate target to 1.75% tomorrow, third in this cycle, is a foregone conclusion. The bond market rally since mid-summer, however, has been driven by a sizeable unwinding of expectations for Fed action through the end of next year, coinciding with a mood of economic pessimism that seems significantly overdone. To sustain the rally, or even justify keeping yields at these levels, bond bulls need Fed backup for their gloomy view, and we think they're not likely to get it.

Much of the focus in the financial media leading up to the FOMC session has been on whether the central bank is prepared to signal that it could skip a rate hike at one of its two remaining meetings this year, which would put the funds rate at 2%, rather than 2.25%, by year end. The futures markets, however, have largely been priced for that eventuality since shortly after the last FOMC meeting, and long-dated bonds are far more sensitive to longer-term expectations in any case. Since late July, as the 10-year note has rallied by nearly 55 bps, the December 2005 Eurodollar futures have knocked some 87 bps off the short-term rate expected late next year, for an implied funds rate of 2.75 to 3%.

So while press speculation centers on whether the Fed might pass on one tightening move before year-end, futures are now priced for rate hikes emerging from -- at most -- four of the nine scheduled FOMC meetings next year (assuming this year ends with the target at 2%). But based on recent comments of Fed officials, as well as forward-looking indicators of the economic outlook, that seems a dubious proposition. **Janet Yellen**, a former Fed governor recently installed as president of the **San Francisco Fed**, provided an unusually prescriptive outline of the policy outlook earlier this month, asserting that rates "need to rise considerably" to reach a "neutral" level of 3.5 to 4.5%. Fed governor **Susan Bies**, meanwhile, last week said "our main direction is up." Bies also remarked that there was "no urgency" to raise rates, but her comments seemed intended to remain consistent with the theme that the Fed would continue to pursue a "measured" course of rate normalization, not that it was considering an even less forceful approach.

Of course, our primary concern during this period has been that the Fed's gradualism would be inadequate to the task at hand. Market price indicators, including the price of gold remaining solid in a trading range above $400, reflect considerable doubt that on its present course the Fed can stanch the liquidity surplus engendered by having remained too easy for too long soon enough to avoid a period of significantly higher inflation. As it is, core CPI is now running at a rate of 1.7% year-on-year which, while not particularly alarming in its own right, is up from 1% at the end of last year. Given the lags involved, we see that trend in second differences continuing until the year-on-year rate reaches at least 3% within the next year. Based on that outlook, the worst thing the Fed could do now would be to attempt to placate the bond market by offering a more dovish perspective in tomorrow's statement. Fortunately, that appears to be a low probability at this point. TM