TrendMacrolytics

Donald Luskin, Chief Investment Officer
David Gitlitz, Chief Economist
Thomas Demas, Managing Director

TRENDMACRO LIVE!

On the FOMC Meeting

Tuesday, March 28, 2006
David Gitlitz

As we forecasted would be the case, this new-look **Fed** -- with a rookie **chairman** and two new **governors** -- was intent on signaling that it would maintain continuity with the pre-existing **policy** thrust, giving little solace to those expecting any hint of a near-term end to this **rate-hiking cycle**. In the wake of today's **FOMC** meeting, the **fixed income markets** have begun pricing for the Fed raising rates higher and keeping them there longer than they had previously expected. In post-meeting trading, longer-dated **interest rate futures** were aggressively unwinding any **expectations** that the Fed would be entering **rate-cut** mode by the first half of next year. At the same time, nearer-term futures, which had been priced for the **funds rate target** topping out at 5% following the May meeting, were making a nascent bet that the rate would be moving to 5.25% by later this year. In accordance with those shifting expectations, the **10-year Treasury** was down more than half a point, the **yield** posting a new two-year high of 4.78%.

Although the FOMC's statement suggested that, following the current quarter of strong growth, the expansion is "likely to moderate to a more sustainable pace," it's clear that under their **demand-management** approach, potential **capacity constraints** remain a primary concern. Sticking with the formulation contained in the previous statement in late January when **Alan Greenspan** was still at the helm, the committee cited "possible increases in resource utilization" as an **inflation risk** factor. The statement also cited high **energy prices** as an element of the inflation risk picture, but for the first time added a reference -- twice -- to "other commodities." This wrinkle could offer a hint that new chairman **Ben Bernanke** is not averse to integrating market price indicators into the Fed's policy framework. At the same time, we believe that one of the new governors, **Kevin Warsh**, is attuned to the monetary significance of **commodity prices** -- so the reference could have been an acknowledgement of his concerns.

One way or another, though, it all adds up to maintaining the bottom-line assessment that "some further policy firming may be needed." We think that had the FOMC reached consensus that one more rate hike -- to 5% -- would likely complete their task, they would have found some way of encompassing that assessment in this statement. Absent that, we believe the Fed is setting itself up for at least two more hikes. At the same time, though, it's also the case that the policy outlook remains **"data dependent,"** meaning expectations could remain highly **volatile** in response to **economic news**. It's our analysis, however, that the underpinnings of this economy remain strong, and that any apparent softness in the data might create short-lived trading opportunities and expectations shifts, but are unlikely to fundamentally change the policy outlook. At this point, our call is that the funds rate reaches 5.25% at the June meeting, and that while the **yield curve** will remain flat relative to its overnight rate anchor, it is unlikely to invert. The **long end** of the curve, in other words, remains vulnerable. TM

http://www.trendmacro.com
don@trendmacro.com
dgitlitz@trendmacro.com
tdemas@trendmacro.com

Offices:
Menlo Park CA
Parsippany NJ
Charlotte NC

Phone:
650 429 2112
973 335 5079
704 544 6900