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Huh?

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The Fed may be on pause longer now, but nothing in yesterday's FOMC statement justifies the fantasy that rate cuts are coming.

The markets' reaction to yesterday's FOMC statement both confirms and flummoxes our strategic view. For equities, we are well on the way to having been proven correct in saying that the recent sharp correction was only that -- a correction (see "Enough Good News for a Correction" February 16, 2007 and "Are We Scared Yet?" February 28, 2007). Stock's were buoyed by the statement's more cautious tone on economic growth, which would seem to indicate that the Fed will do nothing anytime soon to lessen the superabundance of liquidity which we believe insures the economy against the shock of the subprime crisis (see "All Tip, No Iceberg" March 16, 2007). But the reaction in fixed income markets -- long-term Treasuries rallying, and interest rate futures increasing their expectations for Fed rate cuts -- makes no sense to us. Yes, the Fed's present rate pause has no doubt been extended a bit -- but that should be no surprise. Nothing in the statement suggests that the Fed has become any more likely to *cut* rates. In fact, numerous inexplicable media analyses to the contrary notwithstanding, the FOMC statement in our view unambiguously strengthened the Fed's tightening bias, by re-emphasizing and more clearly defining the risk of inflation.

Much has been made of the downgrade to growth prospects between last meeting's statement and yesterday's. In January the Fed spoke of "somewhat firmer economic growth, and some tentative signs of stabilization...in the housing market." Yesterday it was

Update to strategic view

US STOCKS: The Fed on continued pause as an insurance policy against growth risk arising from the subprime sector is good for stocks in the short to intermediate term. We continue to believe that the recent decline has been nothing more than a correction. Longer term, stocks are threatened by the Fed's eventual need to act decisively to contain a mounting inflation threat.

INFLATION PLAYS (US RESOURCE STOCKS, US ENERGY STOCKS, GOLD, COMMODITIES, US DOLLAR): With the Fed on extended pause, inflation-sensitive sectors should continue to be star performers, as they have been throughout the recent stock market correction (and the dollar should continue to weaken).

US BONDS: Bonds rallied on yesterday's FOMC statement, but we suspect that in very short order a more rational reading of what the Fed actually said will result in the realization that a continued pause is a far cry from the rate cuts the markets are currently pricing for.

[see Investment Strategy Dashboard]

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that "indicators have been mixed and the adjustment in the housing sector is ongoing." But *both* statements contained the identical optimistic forecast that "the economy seems likely to continue to expand at a moderate pace over coming quarters."

Less emphasis has been put on the way yesterday's statement dealt with inflation. January's statement was hopeful, noting that "Readings on core inflation have improved modestly in recent months" and warning only that "some inflation risks remain." But yesterday's statement was considerably darker, noting that "Recent readings on core inflation have been somewhat elevated" and warning that the "predominant policy concern remains the risk that inflation will fail to moderate as expected." When the FOMC states flat out that that it's *predominant policy concern* is that inflation may not fall *from its current elevated level*, we can't imagine any justification for thinking that the Fed has done anything but intensified its tightening bias.

We suspect that the market's obliviousness to this seemingly clear warning will frustrate and alarm the Fed. One senior Fed official told us recently that while it is generally a good thing for inflation expectations to be contained, the market's irrational denial of inflation is ultimately a risk. Monetary policy, he told us, is not like fashion: "We can't say 'brown is the new black.' We can't allow 2.5% inflation to become the new zero." In other words, at some point the Fed is going to have to act to bring inflation down to prevent the market from re-basing its expectations at a level that is already above the upper bound of the Fed's avowed comfort zone.

But for the moment the Fed's hands are tied. The recent subprime crisis is seen as yet another potential systemic threat -- like the threat of deflation in 2002 and the threat of the housing cool-off in mid-2006 -- requiring the Fed to be more accommodative than it would like to be in order to insure against an unlikely but intensely negative worst-case outcome. Every time the Fed insures this way, the "insurance premium" is paid in the form of more inflation pressure packed into the pipeline. Yesterday, after the FOMC's announcement confirming the purchase of yet another insurance policy, the most inflation-sensitive markets reacted just as we would expect -- gold and oil jumped, and the forex value of the dollar fell. As we forecasted, over the course of the stock market correction since the February 20 top, while the S&P 500 is still down 1.7%, the inflation-sensitive sectors have been stand-out performers -- energy is up 1.8%, and materials is up 0.3% (see "Something's Survived" March 8, 2007). The Fed's continued pause may or may not be necessary to assure the graceful collapse of excesses in the subprime market (we don't think it is), but one thing's for sure -- it's an accelerant to an already dangerous inflation situation. And the inflation-sensitive markets will continue to reflect that.

Having been frustrated bond bears for as long as we have been, perhaps we shouldn't be surprised that the inflation risk inherent in the Fed's continued pause is being ignored by fixed income markets -- or even that the Fed's manifest hardening of its tightening bias is being interpreted as a softening. But then again, we have to note that yesterday the 10-year yield finished the day at 4.54% -- which is 14 basis points higher than it was in early December, when the Fed's tightening bias was supposedly harder. Either yesterday's news from the Fed wasn't as dovish as it was made out to be, or the bond bulls are running out of bullets -- or both.

BOTTOM LINE: The Fed on continued pause as an insurance policy against growth risk arising from the subprime sector is good for stocks in the short to intermediate term. We continue to believe that the recent decline has been nothing more than a correction. Longer term, stocks are threatened by the Fed's eventual need to act decisively to contain a mounting inflation threat. Until then, inflation plays have been stars during the correction, and should continue to outperform the market. Bonds rallied on yesterday's FOMC statement, but we suspect that in very short order a more rational reading of what the Fed actually said will result in the realization that a continued pause is a far cry from the rate cuts the markets are currently pricing for.