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FED SHADOW

The Fed Gets it Right

Wednesday, August 8, 2007

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Thankfully no pandering to panic-mongers, but rates likely stuck on hold now until 2008.

Despite all the loud chatter that the Fed needed to send a clear signal that it was poised to respond to the recent financial market turbulence, the FOMC yesterday appears to have struck exactly the right note. While acknowledging the market volatility and tightening of credit conditions for "some" borrowers, the Fed maintained its outlook for a "moderate pace" of expansion "supported by solid growth in employment and incomes and a robust global economy." Importantly, it also stuck with its bias targeting inflation as its "predominant policy concern," noting that "a sustained moderation in inflation pressures has yet to be convincingly demonstrated."

As we forecasted Monday, the Fed's soothing approach is acting as a salve for market sectors most heavily battered in the last few weeks of fear and angst, but taking a heavy toll in fixed income markets that had seized on the turmoil to drive prices up and yields down (see ["Bernanke Won't Hit the Panic Button"](#) August 6, 2007). We said, "A Fed statement... which takes a composed and unruffled tone may well help instill a less anxious perspective in the markets -- likely diminishing rate cut expectations and at the same time, somewhat paradoxically, begin spurring a reversal in the safe-haven plays.". At 4.85%, the 10-year Treasury yield is up more than 10 basis points from its pre-FOMC levels, while Eurodollar futures have reversed up to 15 basis points of their bet on the likelihood of Fed rate-cutting action. We note, though, that even with this sell-off, futures remain priced for a better than even chance of one 25 bp rate cut in December and more than one cut by next June. One month ago, those futures were priced for a minimal chance of Fed action and the benchmark Treasury yield was about 5.2%. We expect to see these markets continue moving back toward those levels.

Realistically, the best outcome of yesterday's meeting for those hoping for a more dovish result would have been a shift to a neutral policy stance, jettisoning the inflation bias. But the equity market's positive response even in the absence of such a shift is instructive. It suggests that the market has been beaten down by exogenous risks factors and sheer panic (see ["Burned Out"](#) August 7, 2007), but that the fundamental upside is not dependent on hopes for Fed rate cuts.

Update to strategic view

FED FUNDS: Yesterday the Fed calmed markets by, paradoxically, not moving to bail out the present credit distress. But that distress seems likely to keep the Fed on pause at 5.25% until 2008. This exacerbates our longer-term concerns that building inflation pressures will cause the Fed to eventually have to raise rates to restrictive levels.

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It's also consistent with our view that policy remains accommodative and that the recent market upheaval has in no way reflected a scarcity of dollar liquidity.

BOTTOM LINE: The Fed took an important step yesterday in helping to restore market confidence by rejecting entreaties for an overt response to recent market turbulence, and maintaining its focus on the inflation risks that remain at hand. With the dollar already in a weakened state, any Fed nudge in the direction of an easier stance might well have sparked a serious downdraft for the currency, a consideration that could have factored into yesterday's deliberations. But while we are encouraged by the Fed remaining poised and calm in the face of the market turmoil and calls for its direct intervention, it doesn't alter the fact that the Fed's accommodative posture still will need to be redressed at some point. While previously we had seen that further policy adjustment as likely to begin before the end of this year, recent events probably have moved that timeline into 2008. It's an open at this point whether that further delay ultimately will require the Fed to do even more to restore monetary equilibrium when it finally is compelled to take action. ▶