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FED SHADOW

Bonds Wish, Stocks Worry

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Markets are wrong if they believe that yesterday's FOMC statement puts the Fed on hold.

Yesterday, when the Fed balanced its growing concern about inflation by voicing continuing unease about the economy, and maintained that it expects inflation to "moderate" in coming months, it allowed fixed income and commodity markets a breather from expectations of an early and forceful shift into rate-hiking mode. But based on today's distressed reaction in equity markets and in the dollar, that breather is in fact disappointment that the Fed has been so timid in embracing an inevitable turn toward more normal rates. We continue to expect such a shift (see "Hikes Are Coming, and Not a Moment Too Soon" June 19, 2008), so we think the bond and commodity markets' relief -- and the equity and dollar markets' distress -- is unlikely to be sustained for long. Data in coming months will likely show the economy to be stabilizing, and will likely will not confirm the Fed's hopes that inflation will moderate.

Update to strategic view

FED FUNDS: Yesterday's FOMC statement is being interpreted as dovish, with fixed income and commodity markets showing relief -- while equity markets and the dollar show distress. We think the FOMC's message was more hawkish than the markets choose to realize today, and continue to expect that the Fed has positioned itself to begin to hike rates beginning with the August FOMC meeting.

[see Investment Strategy Dashboard]

Actually, we see the FOMC as having taken at least a marginal turn toward hawkishness with yesterday's post-meeting statement, upping its inflation risk assessment while at the same time deemphasizing downside growth risks. "Although downside risks to growth remain, they appear to have diminished somewhat, and the upside risks to inflation and inflation expectations have increased," the FOMC said. Following its last meeting in late April, the FOMC said "economic activity remains weak." Yesterday, it said "overall economic activity continues to expand." This shift in language essentially takes the Fed off recession watch, giving it the leeway to begin reversing the 325 basis points in rate cuts effected beginning last September. Yes, the statement also says that "tight credit conditions, the ongoing housing contraction, and the rise in energy prices are likely to weigh on economic growth over the next few quarters." However, it maintains that the "substantial easing of monetary policy" along with the credit facilities established to provide liquidity and relieve market stress "should help to promote moderate growth over time." Under this formulation, the policy outlook hinges on how quickly the data confirm a restoration of "moderate growth." We see gathering signs that such a restoration is now underway, with the current quarter likely to post a real growth rate in a range around 2%.

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As for inflation, the assertion that a moderation is expected "later this year and next year" should primarily be seen as part of an effort to rein in public price level expectations, which have been accelerating. At the same time, though, the FOMC noted the "elevated state" of inflation expectations, and it dropped the claim from the April statement that an "easing of pressure on resource utilization" should lead to reduced price pressures. In fact, the statement provides no support for its claim of an expected moderation in inflation, but notes that "uncertainty about the inflation outlook remains high." All in all, we view this language as a substantial shift in acknowledging the increasingly troublesome elements in the developing inflation environment. Reported headline inflation is now running at about 4% year-on-year, up from less than 2% last summer, and has actually been restrained in recent months by some quirky seasonal adjustment factors. Those factors are due to wash out over the next few months, renewing the uptrend. Push could soon come to shove for the Fed on the inflation front, leaving it little choice but to begin taking back the rate cuts.

The Fed yesterday made no mention of the dollar in its post-meeting statement, but Fed chairman Ben Bernanke's recent speech recognizing the inflation risks entailed by a weakening currency should be borne in mind, especially in the context of expected action by the Fed's counterparts at the European Central Bank (see "The Bernanke Awakening" June 5, 2008). ECB officials have become increasingly alarmed by the uptrend in reported European inflation, and have left little doubt that at least one rate hike is in store, probably next month. Should that have the effect of strengthening the euro versus the dollar, it could be another factor inclining the Fed to begin the rate hiking process sooner rather than later.

In yesterday's policy action, there was only one dissent against the decision to hold the funds rate steady at 2%, that by Dallas Fed president Richard Fisher, who wanted an increase in the target rate. In the previous two meetings, Fisher was joined in dissent by Philadelphia Fed president Charles Plosser, arguing not for rate *hikes*, but rather against further rate *cuts*. Plosser's decision not to join in the dissent at this meeting could well represent an assessment on his part that the committee had moved in a more hawkish direction, satisfying his concerns.

BOTTOM LINE: Fixed income markets read the Fed's message yesterday as indicating it is no hurry to begin moving to normalize policy, and so are shifting expectations against the prospect that rate hikes will come as early or be as forceful as had been anticipated. We'd be cautious about buying into that notion too aggressively. From a balance of risks perspective, the Fed yesterday clearly upped its recognition of upside inflation risks versus downside risks to growth. As the data flow confirms that the economy is in better shape and inflation worse, we still expect policy will move expeditiously into rate-hiking mode.