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FED SHADOW

From Line in the Sand, to Sand in the Face

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Bullied by gold, oil, the dollar and the futures markets, what can the Fed do to be strong?

Update to strategic view
FED FUNDS: The Fed won't dare to disappoint the markets and fail to cut the funds rate by 25 bp tomorrow. But the FOMC's statement may experiment with hints that the markets shouldn't take further cuts for granted. **US RESOURCE STOCKS, GOLD, OIL, COMMODITIES, DOLLAR:** The FOMC's lowering future rate cut expectations would trigger a short-term reaction in inflation-sensitive sectors, but with growth intact and the Fed still easy, inflation-driven trends remain in motion.
[see Investment Strategy Dashboard]

Quantum Fund co-founder Jim Rogers in an interview yesterday called Ben Bernanke a "madman" whose "main goal is to print money." We don't agree. Bernanke simply has no choice now but to "print money" by cutting the funds rate at tomorrow's FOMC meeting, no matter what inflation alarms are being sounded by gold, oil and the dollar. Right or wrong, Bernanke is focused on managing the risks of an illiquidity-driven housing collapse. And besides, markets have bullied him into it. Last week's bout of renewed volatility didn't end until futures markets became priced to reflect the full certainty of a 25 bp rate cut, where they've remained even as markets have generally calmed over the last week. Fearing more turbulence in credit markets and its possible consequences for jobs and spending, we don't think Bernanke will dare to disappoint. In fact, the Fed never has, even in less trying times.

According to our research, stocks are correlated with Fed surprises, although weakly so and with notable exceptions. Generally, when the Fed cuts less than expected (or hikes more), stocks fall on the day of the FOMC meeting. When the Fed cuts more than expected (or hikes less), stocks rise. But big surprises are very rare, especially when rate *cuts* are expected. In fact, there has never been a single instance in which the futures markets *fully* expected a rate cut the day

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before an FOMC and didn't get one. The closest thing on record to such a disappointment is December 1999, when the futures markets assigned a 70% chance of a cut from 5.5% to 5.25% the day before the FOMC meeting, and the Fed did nothing. Emblematic of those heady times, the S&P 500 rose 2% on what should have been bad news. But there's nothing heady about *these* times, except in inflation-sensitive markets. A more likely parallel in Ben Bernanke's mind is the next biggest disappointment on record, one year later in December 2000, when the futures markets assigned a 50% chance of a cut from 6.5% to 6.25% the day before the FOMC meeting, and again the Fed did nothing. Stocks fell 1.1% on the disappointment, and kept falling. Less than two weeks later, the Fed realized its error and cut rates 50 bp in an unscheduled surprise move. Recession set in three months after that.

The historical record doesn't necessarily prove the Fed is afraid to disappoint the markets. It could simply be that the futures markets are very skilled at guessing what the Fed will do. But this week, *both* explanations are probably operative. The markets are guessing, probably correctly, that the Fed will more highly weight the remote (but potentially catastrophic) risk of an illiquidity-driven housing collapse than the proximate (but presumably containable) risk of higher inflation. At the same time, an important risk to growth now is markets themselves -- specifically the fragility of credit markets. So if ever there was a time when the Fed didn't want to disappoint market expectations, this is that time. So the Fed is now particularly vulnerable to being bullied. Last week we called the market's recent bout of volatility a "tantrum" designed to hector the Fed into cutting rates (see "Financials Stink Up the Joint" October 25, 2007). But maybe a better description would be to call last week's surge in rate cut expectations a successful speculative attack on the Fed.

We wrote almost a year ago, several months after the Fed had prematurely paused its rate hiking cycle at 5.25% in August 2006, that "markets are bullies -- they sense weakness and challenge it" (see "Walk the Hawk" November 30, 2006). We concluded that inflation-sensitive markets would challenge and exceed their highs of May 2006, having only temporarily been turned back by new Fed chair Bernanke drawing what we called a "line in the sand," using words -- but not policy -- to contain inflation expectations. That turned out to be the right analysis. The bullies have crossed the line in the sand, and kicked sand in the Fed's face -- with gold and oil having broken to new highs, and the dollar having fallen to new lows. The Fed is no 97-pound weakling, but at the moment it can't fight back.

One thing the Fed might do to try to be strong here is to use the FOMC statement tomorrow to explore how markets will react to some hints that, after 75 bp in rate cuts, expectations for even more cuts may not be fulfilled. This would be similar to the stance the FOMC took in its post-meeting statement in November 1998, announcing its third and final rate cut in response the Long Term Capital Management crisis (see "2007 and the Ghosts of 1998" August 16, 2007). Then the FOMC noted that "markets have settled down materially" -- as they have today -- but that "unusual strains remain" -- as they do today. Hypothetically, the key sentence from the November 1998 statement could be quoted tomorrow in its entirety without altering a single word: "With the 75 basis point decline in the federal funds rate since September, financial conditions can reasonably be expected to be consistent with fostering sustained economic expansion while keeping inflationary pressures subdued." In 1998, the Fed had already signaled markets not to expect much more easing. Going into that November meeting, the futures markets only assigned a 50% probability to another 25 bp cut over the next three months. So the Fed's statement didn't have any negative impact -- if anything, it was taken as a signal of confidence: stocks closed higher on the day of the meeting, and were almost 5% higher a week later. Today market expectations are much more elevated, more than fully pricing two 25 bp rate cuts over the next three months. So a message as stark as that of November 1998 would be taken as more of a disappointment, with a proportionately more negative reaction. The Fed won't want to risk that. But with markets stabilizing, the economy humming along, and so many inflation alarms being sounded, there may well be hints that further rate cuts are less than a sure thing -- but they are likely to be far more ambiguous than they were in 1998.

A story in today's *Wall Street Journal,* by a reporter reputed to be close to Fed officials, discusses the possibility that easing expectations will be talked down in tomorrow's statement. Markets -- especially inflation-sensitive sectors -- have opened lower this morning, possibly in response. On the face of it, diminished easing expectations ought to turn down the heat on inflation plays. But as we've argued before, we don't think the markets fully appreciate just how easy the Fed already is, and the inflationary consequences of its simply staying on pause at a funds rate of, say, 4.5% for an extended period in the future -- at the same time as the economy fails to slow down (see "Easier and Easier" October 12, 2007). So a small realignment of rate cut expectations may trigger a short correction in the inflation-sensitive sectors, but with growth intact, the Fed easy and likely to stay easy indefinitely, their bull move is likely not yet over.

BOTTOM LINE: The Fed won't dare to disappoint the markets and fail to cut the funds rate by 25 bp tomorrow. But the FOMC's statement may experiment with hints that the markets shouldn't take further cuts for granted. Such expectations management would trigger a short-term reaction in inflation-sensitive sectors, but with growth intact and the Fed in an easy posture indefinitely, inflation-driven trends remain in motion.