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FED SHADOW

Hawk on the Outside, Dove on the Inside

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Yesterday's FOMC disappointed the doves, but the Fed remains tilted toward ease.

The dollar fell to fresh all-time lows against the euro near $1.45, and gold jumped to new cycle highs approaching $800 in the immediate wake of yesterday's ostensibly hawkish FOMC statement. Today these markets are going through a feeling-out process, testing the short-run limits of support and resistance in the somewhat altered parameters of the weak currency trend. Thus we've seen gold range from better than $798 overnight to below $784 in early New York trading, while the euro has been bouncing around in a wide range above $1.44.

There might be an inclination to view the Fed's apparent signal of resistance to additional easing as consistent with at least a bottoming of the dollar at these exceptionally weak levels. But given that the Fed was already in a sub-equilibrium posture even before cutting its overnight rate target another 25 basis points to 4.5% yesterday, and that there was no indication yesterday that the Fed would move rates back up to equilibrium levels in the foreseeable future, we'd expect any pause in the dollar's decline -- and gold's ascent -- to be brief.

Update to strategic view

FED FUNDS: The FOMC signaled that further rate cuts won't be automatic, and that the policy outlook is neutral. But a close reading reveals the Fed is still more worried about slow growth than about inflation, and that it will likely let itself continue to be bullied by market expectations that demand an easy posture. We don't rule out further rate cuts, but even without them, policy is very easy, and will remain so for the indefinite future.

[see Investment Strategy Dashboard]

For all the nearly universal agreement that the statement yesterday was designed to rein in expectations for another rate cut at the December meeting, the FOMC was actually keeping its options open. Yes, the sense of urgency that marked the statement following the September 18 meeting -- when rates were cut by 50 bp -- was toned down considerably in yesterday's release. The FOMC said affirmatively that its action yesterday "*should* help forestall some of the adverse economic effects that might otherwise arise from the disruptions in credit markets." The September statement said, much more tentatively, that the 50 bp cut was only "*intended* to help forestall" them. And after emphasizing the downside economic risks in its September statement -- yet without explicitly taking a neutral view on the balance of risks -- yesterday the committee asserted that "the upside risks to inflation roughly balance the downside risks to growth."

But it's also clear that the Fed remains fixated on the housing downturn, determining that "the pace of economic expansion will likely slow in the near term, partly reflecting the intensification

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of the housing correction." As well, the FOMC added that it will continue to monitor "financial developments" for their potential economic effects. This could easily be interpreted to mean that the Fed will view additional market volatility as conveying significant risk that would require a policy response. Indeed, today's equity market decline, triggered by rumors of capital inadequacy issues at Citigroup, precipitated a rally in fed funds futures upping the probability of a December rate cut from less than 45% at yesterday's close to almost 65% at today's. Ironically, while the stock sell-off can be attributed in good part to heightened credit market anxieties, it's also likely to some extent the reaction we forecasted to the Fed indicating that it is less inclined to cut rates further than many were expecting ("From Line in the Sand, to Sand in the Face" October 30, 2007). So essentially the probability of a Fed rate cut is rising today in part due to the Fed suggesting that it was reluctant to cut rates further. Such is the unstable recursive equilibrium that results from the power of market expectations to bully policy-makers into implementing whatever policy is expected.

The FOMC's balance of risks assessment yesterday also highlighted an inherent contradiction in the Fed's output gap policy model. In declaring that growth and inflation risks are in balance, the Fed wasn't saying that conditions are optimal. Far from it. It sees risk in both the growth and inflation outlook, noting in regard to the latter the "recent increases in energy and commodity prices." But from the output gap perspective growth and inflation are perpetually in a trade-off against each other, theoretically precluding the eventuality of *simultaneously* high inflation and slow growth. In a price-rule model, such contradictions would be avoided because the objective of policy would be to keep the purchasing power of the dollar stable according to some market-based measure of the value of the unit of account. The inflationary consequences of the Fed maintaining an easy policy stance to provide a cushion against potential economic softening, the source of the current intensification of inflation risk, would be ruled out. As would the opposite outcome, when the Fed acts to rein in growth on the erroneous assumption that strong growth causes inflation. Perhaps if at some point the Fed is compelled to face the choice of acting either to restrain higher than acceptable inflation or boost slower than acceptable growth, the manifest flaws in the Keynesian demand-management framework will become impossible to overlook, paving the way for some significant reform in our monetary system.

Our policymakers and much of the domestic economic establishment remain content to comfort themselves that the current quiescence of the official inflation indexes suggest price level risks remain limited. But the consequences of the Fed's long-running easy money posture is becoming difficult to avoid in places around the world where the domestic currency is closely linked to the US dollar. Two articles in today's *Wall Street Journal* highlighted the issue. "Falling Dollar, Inflation Feed Dubai Strife" discusses the growing unrest among Dubai workers arising from the 8% inflation being caused by its currency being fixed to a depreciating dollar. And "Flood of Money Strains Hong Kong's Dollar Peg" describes how the Hong Kong authorities have been forced to sharply increase their interventions to soak up excess dollars and maintain the island's long-standing dollar peg. It's not at all clear, however, that policymakers here perceive to any extent the implications of such stories for the stance of domestic monetary policy.

BOTTOM LINE: After sanctioning two easing steps for a total of 75 bp in direct response to credit market upheavals, with yesterday's post-meeting statement the Fed was essentially signaling that it perceives itself as having done enough to deal with the crisis. That suggests, on the one hand, that as long as the economy remains on a healthy growth track, further Fed action could be forestalled. But it's also apparent that the Fed continues to have significant reservations about the economic outlook, and could still act to preclude lingering downside risks on a preemptive basis. The implications for inflation-sensitive market prices such as the dollar, gold and other commodities is for further erosion of the unit of account as the Fed appears likely to remain in its inflation-biased stance for the foreseeable future.