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FED SHADOW

"Act As Expected"

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The Fed repeats it will only "act as needed," but it's still not likely to disappoint expectations.

Based on conversations this week with voting FOMC members, we get the impression that the Fed is mad as hell, and it isn't going to take it anymore. At least it doesn't *want* to take it any more. Specifically, the Fed wants to counter the widespread perception that it will continually allow itself be bullied into satisfying whatever rate cut expectations the bond market may have (see "From Line in the Sand, to Sand in the Face" October 30, 2007). The Fed definitely doesn't want to cut rates unless it has to. There is high awareness of the inflationary risks engendered by its easing actions since August, reflected in the rise in gold and oil prices and the decline in the dollar's exchange rate (see "Gold's New Line in the Sand" November 20, 2007). And while the Fed's official expectation is for a weakening of growth in this quarter, the policy makers we talked to aren't seeing much statistical or anecdotal evidence for it beyond some normal give-back following an extremely strong third quarter. They respect that the recent steep drop in Treasury yields, and the widening of risk spreads, indicates some degree of worsening distress in the global credit market. They recognize that there is at least the possibility that it portends some kind of systemic breakdown, but from all appearances they regard such as risk as quite remote. In light of the available objective data on the health of economy and the banking system, they feel that the reaction in markets is vastly overdone, and represents either a bout of unwarranted panic -- or a form of speculative attack designed to force the Fed to cut rates whether it wants to or not. From what we can see, there is no evidence of a "bunker mentality," or even a "wartime footing" at the Fed.

Update to strategic view

FED FUNDS: The Fed doesn't want to cut rates again unless it has to, and it doesn't want to be seen as bowing to market expectations. But unless markets improve markedly, we don't think the FOMC will have the courage to do anything but cut again.

US STOCKS, US BONDS: Even if the Fed risks destabilizing markets by not cutting rates again, valuations argue against any substantial further downside in stocks or upside in Treasuries. The equity risk premium touched all-time record levels at Monday's close, and we continue to expect a substantial reversal entailing very strong outperformance by stocks over bonds.

[see Investment Strategy Dashboard]

Pushing back against the markets would be an act of unusual courage. With two weeks to go till the December 11 FOMC meeting, the bond market now *more than fully* expects a rate cut. There is not a single instance on record, when the Fed funds futures markets more than fully expected a rate cut two weeks before an FOMC meeting, of the Fed ever disappointing such

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expectations. To do so now, when markets are so fragile and volatility so high, would be to risk a convulsive reaction that could itself trigger substantially deeper distress in the global credit system. But *not* to do so is risky, too. First, there has to be a limit to the inflationary pressures the Fed is willing to unleash in order to reliquefy the markets (see "Honey, I Shrunk The Dollar" September 28, 2007). Second, for the Fed to be effective it must be credible and independent, not the lapdog of rent-seeking credit markets that would love nothing more than to see the Fed subsidize lower rates to restore the lending activity that had previously been enabled by historically narrow risk spreads. The policy makers we spoke with were clear that that Fed must be the lender of last resort, but it is not the guarantor of the banking industry's preferred business models. Finally, the Fed has the opportunity to restore confidence by itself acting confident, rather than feeding the anxieties that may turn recession expectations into a self-fulfilling prophecy (see "Fear Itself" November 16, 2007).

Between now and December 11 we expect that Fed officials will try to tell the story that a rate cut is not a sure thing -- a story already begun with the neutral bias established at the October 31 meeting, continued with the characterization last week in the meeting's minutes of the last rate cut as a "close call," and echoed in a series of speeches. It's not entirely just talk. If the macro data released over the next two weeks is reasonably strong -- if there's a decent jobs report, and if holiday spending follows through on its strong start on "Black Friday" -- and if there are no substantive ruptures in the global credit system -- and if markets don't get even more turbulent than they already are -- then the FOMC will seriously consider doing nothing on December 11. Even if there is some evidence of softness in the economy, Fed officials have publicly indicated that this will not itself necessarily call for another rate cut -- the cuts made *already* were in anticipation of such softness.

That's the hawkish case, and no doubt the Fed officials who express it are entirely sincere. But that view is belied by Fed vice chair Donald Kohn's speech this morning in which, while dismissing much of the recent turmoil in markets as technically driven, nevertheless sent the clear message that Ben Bernanke's doctrine to "act as needed" in this crisis is the dominant paradigm. If there is new evidence of economic weakness by December 11, given the parlous state of markets, we find it hard to believe that the Fed will not interpret it as evidence of more weakness to come. Even if growth looks surprisingly strong, if rate cut expectations in markets are still as intense as they are today, we think it highly unlikely that the Fed will find the courage to do anything but to "act as expected" -- to make one more 25 bp cut. When push comes to shove, the Fed's "risk control" framework will carry the day. The potentially catastrophic risk of unhinging markets will outweigh the more probable -- yet smaller -- risks of a little more inflation and a little less credibility. They'll put the best face on it by issuing a strongly worded statement emphasizing their neutral bias, and live to fight another day -- January 30, to be exact.

BOTTOM LINE: The Fed doesn't want to cut rates again unless it has to, and it doesn't want to be seen as bowing to market expectations. But unless markets improve markedly, we don't think the FOMC will have the courage to do anything but cut again. Even if the Fed risks destabilizing markets by not cutting rates, valuations argue against any substantial further downside in stocks or upside in Treasuries. The equity risk premium -- the spread between the forward earnings yield of the S&P 500 and the income yield of long-term Treasuries -- marked on Monday its highest level since reliable data became available in 1984. At Monday's close it even exceeded the level observed on October 9 2002, the climax bottom of the longest and deepest bear market since the Great Depression. When today's fears subside, the equity risk premium will return back in the direction of its long-term norm. If it were to return all the way, that would imply some combination of (1) stock prices 59% higher, (2) forward earnings 42% lower, and/or (3) Treasury yields 270 bp higher. We don't know when it will happen. Potentially it's beginning right now. We remain highly confident that we are on the verge of a major reversal of the pattern of the last six weeks, and expect substantial outperformance by stocks over bonds.