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FED SHADOW

It Doesn't Look As Bad Now As it Did Then

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Don't read too much into minutes of an FOMC meeting held the day after the end of the world.

Update to strategic view
FED FUNDS: Despite the downbeat tone of the March 18 FOMC minutes and the specter of the Fed running out of T-bills to sell to support its new liquidity facilities, we expect only one more rate cut of 25 bp in this easing cycle. After that, the inflation cost of this easing cycle will be determined by how long the Fed takes to start moving rates back up to equilibrium.
[see Investment Strategy Dashboard]

The markedly downbeat tone of the minutes from the March 18 FOMC meeting sparked a rally at the short end of the Treasury curve late Tuesday that extended into yesterday on the notion that the end of the easing cycle might be further out than recent indications had suggested (see "Weak Jobs Today, Better News Ahead?" April 4, 2008). Gold prices rallied back above $930 and the dollar sold off as the news appeared to rekindle, at least for now, fears that the Fed could be restoring an essentially open-ended easing stance, with all the attendant worst-case inflationary consequences.

But we think that would be the wrong interpretation to draw from the minutes. Remember, this meeting was held the day after the panic of Monday, March 17, and two days after the Fed-engineered takeover of a dangerously crippled Bear Stearns by JP Morgan. It was also the day after the Fed put in place the liquidity facility opening the discount window to non-bank primary dealers. No doubt, policymakers gathering for the FOMC meeting were still shaken by these events, and it showed in both their downgraded growth forecasts and the tenor of their discussion, as reflected in the minutes. "Stresses in financial markets had intensified noticeably since the January meeting," the minutes say. Participants feared that an "adverse feedback loop" was under way, where restrained credit availability darkens the economic outlook which, in turn, further tightens credit availability. "Several participants noted that the problems of declining asset values, credit losses and strained financial market conditions could be quite persistent, restraining credit availability and thus economic activity for a time and having the potential to delay and damp economic recovery."

Over the weeks since that meeting, however, we have witnessed a notable restoration of stability in the credit markets amid welcome indications that the market's capacity to bear risk is recovering. The easing of systemic risk can be seen in the narrowing of the TED spread, which peaked at above 200 bp in the days following the FOMC meeting, to around 140 bp. The safe haven play in three-month T-bills has unwound by more than 90 bp, on net. Credit availability is

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showing encouraging resilience -- in the last six weeks commercial and industrial lending is up by some 22% annualized. The calming of the credit market panic has inspired a concerted narrowing of risk spreads. The Merrill high yield index spread has come in by about 90 bp from its peak of 862 bps on March 17.

It might be premature to say we're entirely out of the woods. The portfolio of impaired assets on the balance sheets of major financial institutions could contain surprises that cause considerable disruption. Spurts of heightened risk aversion still roil the markets, as seen in today's early 8 bp T-bill rally. However, it appears major progress has been made in stemming the atmosphere of fear and panic due in no small measure to the special liquidity facilities that have been put in place by the Fed (see "Three Quarter Profile In Courage" March 19, 2008). In particular, providing discount window access to primary dealers is serving as a critical backstop for Wall Street investment banks, relieving the fears of system-wide counterparty risk that led to the implosion of Bear Stearns.

In his appearance before the Joint Economic Committee last week, Fed chief Ben Bernanke also took a more upbeat view than was reflected in the minutes, suggesting that the monetary stimulus being put in place by the Fed should pave the way for an economic rebound in the second half of the year (again, see "Weak Jobs Today, Better News Ahead?") Bernanke excised from his testimony last week the phraseology he had been using about the Fed standing ready to "act in a timely manner" to provide insurance against downside risks.

These developments since the March 18 meeting, then, point to the Fed pursuing a marginally less dovish course going forward despite the dour impression left by the minutes, and we continue to see the Fed as most likely to make one more 25 bp cut at the meeting late this month, and then leave its target rate at 2% for the foreseeable future. The course of events since the meeting last month also provide considerable validation for the dissent registered by Dallas Fed president Richard Fisher who, the minutes say, "felt that focusing on measures targeted at relieving liquidity strains would improve economic prospects more quickly and lastingly than would further reductions in the federal funds rate at this point." Fisher also suggested that "alleviating these strains would increase the efficacy of the earlier rate cuts." That's probably true, which also suggests that as calm is restored to the markets, the Fed's stance effectively is marginally easier than it would have been otherwise. The termination point of this cycle likely will not be as dovish as was widely expected until fairly recently -- on March 17 futures were well on their way to pricing for a 1.25% funds rate by June. But its exceptionally easy stance could still become even easier as the markets recover their stability.

The inflation expectations indicators yesterday were probably also given a lift by the leaked report in the *Wall Street Journal* suggesting the Fed is evaluating contingencies for continuing to provide liquidity if they are forced to maintain the draw down of their balance sheet assets, which is what they've been doing to sterilize the targeted liquidity additions. Although Fed officials probably conceived the piece as demonstrating their commitment to continue the liquidity program without expanding the money supply, market players might have read it as indicating that at some point the Fed could exhaust its options, and will be faced with no choice but to run the printing press. But even without that highly unlikely worst-case outcome, the Fed will have to start moving the funds rate up from its likely 2% cycle endpoint in order to keep inflation expectations anchored (see "Inflation Inflection" March 25, 2008).

BOTTOM LINE: The anxious tenor of the minutes of the Fed's March 18 meeting was seized on at the short end of the Treasury yield curve, powering a 15 bp rally in the 2-year note, which is now yielding less than 1.8%. Most likely, though, that's a sizeable overreaction. Since that meeting, markets have begun a process of stabilization and the Fed's angst likely has been considerably relieved. Provided that this progress is sustained, we're looking for one more 25 bp rate cut and then see the Fed remaining on hold indefinitely. The inflation cost of the Fed's easing exercise will now be determined by how long "indefinitely" turns out to be.