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FED SHADOW

FOMC Preview

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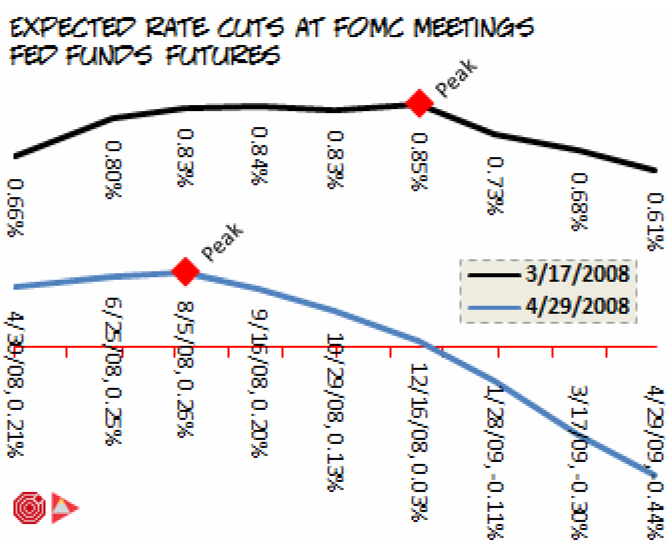
Tomorrow the Fed will pause -- but an end to the easing cycle would be more refreshing.

The Fed has now put through 225 bp in rate cuts since last September, in an exercise that has done far more to sow the seeds of inflation than calm financial markets or forestall an economic slowdown (see "Fed vs ECB -- the ECB Wins" April 23, 2008. According to various leaks it has provided to the media, the Fed is now prepared to signal a pause in its easing campaign following tomorrow's expected 25 bp cut. This is welcome in its own right, in the sense that at least it recognizes the potential damage that indefinite continuation of an open-ended easing posture would do both to the economy and the Fed's already compromised credibility. But the Fed's apparent reluctance to more definitively suggest that the process has come to an end does not inspire great confidence that it is prepared to soon take a stance to ensure that the bulk of the inflationary impulses it has embedded in the system will be kept from feeding through to the general price level.

Update to strategic view
FED FUNDS: At tomorrow's meeting the Fed will cut the funds rate by 25 bp, and will hint at a pause in the easing cycle -- all of which is expected, and thus unlikely to elicit significant market reaction. Should the Fed not cut at all, and/or it signals that this easing cycle is likely over, after a short period of shock we expect risk-sensitive markets to react most positively.
[see Investment Strategy Dashboard]



Several factors have probably influenced the decision by chair Ben Bernanke and other senior officials to go into pause mode. For one, there has been a marked shift in the expectations environment since the Bear Stearns collapse last month prompted the Fed to open the discount window to the primary dealer community (see "The Bear Stearns Bottom: One Month Later" April 17, 2008). A financial system showing signs of being on the verge of meltdown has been restored to a semblance of normality. A particularly encouraging

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response continues to be seen in recovery of the market's capacity to bear risk. In the process, expectations for the scope of further Fed action have been scaled back dramatically. In the panic of March 17, the day before the Fed's 75 bp cut to 2.25%, fed funds futures were priced for another 75 bp in cuts by the June meeting, with the rate expected to remain at 1.5% for the rest of this year, and likely into next. Today, the futures curve shows that tomorrow's anticipated 25 bp cut to 2% is expected to be the last one, with rate hikes beginning as soon as the October FOMC meeting. A year out, the futures curve is now priced for more than an 80% probability of a funds rate target of 2.75%. Given the extent to which Bernanke has been captive to market expectations in this policy cycle, it's unlikely he and his cohorts would have felt free even to contemplate a pause in the absence of this expectations shift.

Our monetary czars are also being buffeted by the appearance of some distinctly unfriendly reviews of their performance. They have been aware of our own critiques all along, but now it's coming from sources that must feel uncomfortably close to home. Earlier this month, in an op-ed in the *Wall Street Journal* titled "Behind the Food-Price Riots," Vincent Reinhart, who served for years as the Fed's top monetary policy staffer, called attention to "monetary policy in overdrive" as being a critical factor behind the escalation of food prices. Noting that the real funds rate has moved decisively into negative territory, Reinhart wrote, "The last time the real funds rate was negative for a prolonged period was the mid-1970s. This was also a period when overstimulated demand pushed food prices up and the dollar depreciated sharply. In the end, economic growth suffered as well. Remember stagflation?" Reinhart only left the Fed within the last year, and for a former senior Fed staffer to be calling out his colleagues in such a straightforward public manner is very unusual. It had to have a sobering impact within the marble walls of our central bank.

There has also been a string of recent media reports questioning Bernanke and the Fed's preparedness for the task at hand. "Federal Reserve chairman Ben S. Bernanke may have to start talking and acting more like Paul Volcker if he wants to avoid being remembered as another Arthur Burns," said a Bloomberg article yesterday. The piece quotes from Volcker's April 9 speech at the New York Economic Club, where he noted that "there are some resemblances between the present situation and the period in the early 1970s." That's when Burns was at the Fed's helm, presiding over the initiation of an historic inflationary spiral. "There was some fear of recession, the oil price went skyrocketing up, the dollar was very weak," Volcker said. As an active Democrat, Volcker's remarks may have had political motivations. But Fed officials are highly sensitive about their press treatment, and spend considerable effort to ensure that it is as favorable as possible. They are not immune to media reports that raise issues regarding the appropriateness of policy, especially when the questions are raised by someone with a reputation for probity such as Paul Volcker.

At the same time, though, the Fed appears to regard it as premature to entirely close the door on the possibility of further rate cuts. Still seared by last month's near-death experience, top officials worry that markets could potentially return to that fearful state if the Fed announcement is regarded as disappointing. Policymakers likely are still swayed by the fact that the statement last October suggesting that upside inflation risks "roughly balanced" downside growth risks was seen as contributing to the renewed eruption of market turmoil. And while downside economic risks appear to have been mitigated somewhat in recent weeks, the Fed remains on alert to an "adverse feedback loop," under which the restraint on credit availability dampens the economic outlook, which in turn further tightens credit availability. As a result, tomorrow's FOMC statement is likely to cast the policy outlook as highly "data dependent," suggesting a willingness to cut rates further if warranted by economic conditions.

From our perspective, that would represent a lost opportunity for the Fed to continue the difficult task of restoring its credibility, following its first tentative foray into a less accommodative posture, when it risked disappointing market expectations in March by cutting by 75 bp instead of the expected 100 (see "Three Quarter Profile In Courage" March 19, 2008). It would also be an opportunity for the Fed to provide some degree of confidence that it is prepared to soon meet the challenge of restoring the dollar's lost purchasing power. At this point, a "data dependent" Fed implies that it is willing to countenance further erosion of the unit of account in order to avoid additional economic weakness. The greatest threat to the economy, however, will come if the Fed follows through on that, and is forced later into a draconian tightening response to subdue the inevitable inflationary consequences.

BOTTOM LINE: The gold price today has fallen to its lowest levels in more than three months, near $870, in further apparent recognition that the Fed is moving away from a worst-case inflation scenario (see "Inflation Inflection" March 25, 2008). Tomorrow's FOMC meeting would afford the Fed an opportunity to build on that, an opportunity it appears disinclined to take at this point. We think that rather than courting risk of additional market turmoil, a clear signal from the Fed that it sees the easing process as likely having come to an end would contribute to furthering the recovery of market confidence, giving the dollar a significant boost and indicating that the process of restoring monetary equilibrium was being put in motion.