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FED SHADOW

Too Soon to Stray

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Markets should be relieved tomorrow when the Fed stays the course.

Update to strategic view
FED FUNDS: Tomorrow's FOMC statement will only slightly nuance the Fed's stance on growth prospects and inflation risk. It will acknowledge that the worst of the economic emergency has passed, while the shape and timing of recovery remain unknown. **US STOCKS, US RESOURCE STOCKS, GOLD, COMMODITIES, OIL:** A steady-as-she-goes statement from the FOMC will relieve fears of premature tightening. But ambivalence about the shape and timing of recovery and the small but intense risk of a deflationary mistake at the Fed should keep markets in correction-mode for a while yet.
[see Investment Strategy Dashboard]

Coming into this week's FOMC meeting, markets seem to be signaling the Fed that it's too soon to consider pulling back from its generous liquidity posture. Over the last week stocks, Treasury yields and commodities are lower, risk spreads have widened, and the dollar is higher -- all pointing in the direction of deflation and slow growth, and all telling the Fed not to cool its jets just yet. Expectations for Fed tightening showed up suddenly with the release of the May employment report (see "On the May Jobs Report" June 5, 2009), with the Fed funds futures market's forecast for the funds rate in June 2010 leaping from 1% to 1.6% (see the chart at left). With that signal from the labor market that the worst of the recession is over, the market's attention has shifted away from the risk of falling into an economic abyss, and toward a debate about the timing and shape of recovery (see "The Case for Ambivalence" June 12, 2009). The

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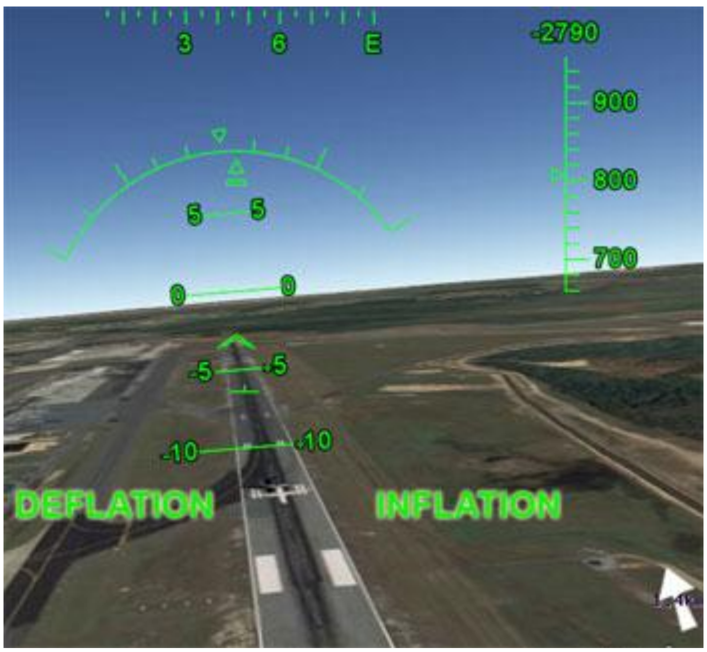
Fed is apparently going through the same debate, giving reason for concern to markets accustomed to endless expansion of monetary liquidity in the name of emergency. For example, in congressional testimony Ben Bernanke spoke more of green shoots, and of the "receding" risk of deflation (see "They Laughed When I Sat Down to Monetize" June 4, 2009). And surprising to us, the Fed did nothing earlier this month, in markets or by speechifying, to intervene to stop the sharp rise in Treasury yields (see "No, Mr. Bond, I Expect You to Die" May 22, 2009).

Against this backdrop, we don't expect tomorrow's FOMC statement to be very much changed from the April meeting's statement. Economic slack is unlikely to be characterized again as "increasing…here and abroad," but rather as tentatively stabilizing. And the risk of deflation -- which the FOMC refers to as "inflation…below rates that best foster economic growth" -- will likely be characterized as having receded somewhat. We think there is very little chance that the Fed will say anything directly indicating an intention to raise the funds rate or actively shrink its balance sheet any time soon. Something like this would seem to be approximately consistent with the futures markets, which have given back half the jump in expectations for rate hikes seen after the May jobs report (again, see the chart on the previous page).



All that said, these things are mere details that pale in significance against the Fed's overarching operating framework. That framework is all about *risk management*, in which any possibility of deflation must be insured away by deliberately inducing inflation. This risk management framework is all the more important to the Fed *now*, in light of the chaotic state of the economy and the markets, in which the Fed has more than the usual amount of uncertainty about how to carry out policy -- and in which deflation was actually experienced at near-Depression levels just six months ago. For the Fed, it's like trying to land a damaged airplane -- there's no way such an airplane can be put down at some exact point on the runway, just as the Fed now is powerless to precisely deliver any particular inflation outcome, such as Bernanke's desired target of 2%. In fact, the pilot *knows* he will miss the runway altogether -- it's only a question of in which direction he misses. If he misses the runway to the left, that is, if policy is too tight, he will land the economy in deflation -- a catastrophe, in the Fed's mind. If he misses it to the right, that is, if policy is too loose, he will land the economy in inflation -- not ideal, but not a catastrophe. So the *risk management approach is to aim toward inflation deliberately*, to not even try to hit the runway.

We have absolutely no doubt that the Fed sees the world exactly this way, and that it will indeed veer toward inflation. The Fed believes that economic slack is a buffer against inflation, so it will not be inhibited by inflationary costs from a sharp veer in that direction (see "Fed Says, Give Us Some Slack" May 6, 2009). But as it veers, it will insist that it is not doing so. The Fed believes that inflation expectations are a cause of inflation, so it will not wish to say anything that would aggravate them. But in the market's view, apparently, there remains some chance being factored into the probability distribution that the Fed won't veer enough, and that we could fall back into deflation. That risk -- though small -- is why, despite the historically easy policy posture now adopted by the Fed, inflation-sensitive markets like gold haven't broken to new highs (see "Why Isn't Gold at $1500?" December 10, 2008). And it's part of why stocks are off almost 6% from their closing high ten days ago -- when we said "it will soon be time to trade this 'tradable rally'" (again, see "The Case for Ambivalence"). We expect that what amounts to a holding statement from the FOMC tomorrow will mitigate that risk somewhat, and could be the occasion for at least some rally in the overall context of the correction in stocks and in inflation-sensitive markets.

BOTTOM LINE: Tomorrow's FOMC statement will only slightly nuance the Fed's stance on growth prospects and inflation risk. It will acknowledge that the worst of the economic emergency has passed, while the shape and timing of recovery remain unknown. A steady-as-she-goes statement from the FOMC will relieve fears of premature tightening. But ambivalence about the shape and timing of recovery and the small but intense risk of a deflationary mistake at the Fed should keep markets in correction-mode for a while yet.