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On the August FOMC

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Not buying more Treasury bonds is hardly news, and hardly an exit strategy.

Update to strategic view
FED FUNDS: There's no exit strategy implicit in the FOMC's decision to stop buying long term Treasuries when the $300 billion program is complete. Inflation pressures will continue to build.
[see Investment Strategy Dashboard]

We see nothing of particular impact in today's FOMC statement. By saying "economic activity is leveling out," the Fed is acknowledging what we observed in early May (see "Stress Test for T-Bonds" May 8, 2009), and what everyone now knows -- that the recession has already hit bottom. At the same time, saying "substantial resource slack is likely to dampen cost pressures, and the Committee expects that inflation will remain subdued for some time," the Fed remains unconcerned about the inflation risk associated with the enormous growth of its balance sheet. With the deflationary demand for money still quite high -- which is *related to* resource slack, but by no means the same thing -- the Fed is not wrong to see no *immediate* threat. The challenge will come when money demand falls. Resource slack will likely still be viewed as "substantial" then, so it remains to be seen whether the Fed will have the wisdom and/or the political will to appropriately shrink its balance sheet in the face of it (see "Check the Exit" July 22, 2009). We are hopeful, but far from optimistic.

No comfort should be taken by today's revelation that the Fed will not enlarge its program to buy $300 billion of long term Treasuries. That was the indirect but unmistakable implication of a sentence in the statement overtly saying only that the pace of buying would be slowed as the program reaches its goal: "To promote a smooth transition in markets as these purchases of Treasury securities are completed, the Committee has decided to gradually slow the pace of these transactions and anticipates that the full amount will be purchased by the end of October." With the market having waited to see whether the FOMC would announce today any specific exit plans, it is no help -- and no surprise -- to learn that this finite program will not be made larger, given the self-evident improvement in the economy. And as we reported to clients three weeks ago, according to highly placed Fed sources, the FOMC now unanimously believes that this program was a mistake to begin with, and it is only even completing it in order to maintain the outward appearance of consistency (see "The Fed's Bond Boo-Boo" July 24, 2009).

BOTTOM LINE: There's no exit strategy implicit in the FOMC's decision to stop buying long term Treasuries when the $300 billion program is complete. Inflation pressures will continue to build.

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