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TRENDMACRO LIVE!

On the August FOMC

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It was not quite the least the Fed could do, but they did it. There's more to come.

Today's FOMC took a small step, but more than a baby step, toward further easing. At first blush, it was enough to keep markets from destabilizing even in light of the overheated expectations environment that has developed over the last couple weeks, and to launch at least a modest rally from earlier lows. This is Ben Bernanke's preferred policy of "gradualism" in all its modest glory -- the *least* that could be done without triggering a massive sell-off.

Of the two measures we anticipated the Fed might take (see "What Should the Fed Do?" August 5, 2010), the FOMC chose the least effective one -- to "keep constant the Federal Reserve's holdings of securities at their current level by reinvesting principal payments from agency debt and agency mortgage-backed securities in longer-term Treasury securities." We would have preferred to see an explicit minimum duration declared for the "extended period" of "exceptionally low levels of the federal funds rate." This would have reduced uncertainty about future Fed moves at a time when markets are desperate for stability in all policy domains.

We think this would have been Ben Bernanke's first choice if he were deciding unilaterally. While still very much gradualist, it would have been a somewhat bigger step than the one taken, given the controversy about it fomented by Kansas City president Thomas Hoenig's long-standing opposition -- and compounded in recent weeks by theoretical work opposing it from St. Louis president James Bullard. Today Hoenig went so far as to expand his dissent to include opposition to maintaining the Fed's balance sheet at its present size, and to rationalize it by the judgment that "the economy is recovering modestly, as projected."

This puts Hoenig totally out of consensus with the rest of the committee. The FOMC statement was a cavalcade of downgrades, portraying an economy behaving very much *not* as expected. It doesn't get any clearer than this line: "…the pace of economic recovery is likely to be more modest in the near term than had been anticipated."

Business investing is "rising," but not "significantly" as was thought at the previous FOMC. In addition, household spending is now said to be

Update to strategic view

FED FUNDS, US MACRO: Today's FOMC took something more than a baby step toward easing, which helps alleviate the risk of a 1937-8 policy error of premature tightening. But fell short of the ideal move of making the "extended period" explicit, a missed opportunity to alleviate the crippling policy uncertainty holding back growth. The "expansionless recovery" will continue, and the Fed will likely be pressed to more easing later this year.

US STOCKS, US BONDS, US RESOURCE STOCKS, HI-YIELD BONDS, GOLD, OIL, COMMODITIES: The Fed's modest action today is enough to keep rates low across the curve and down the quality spectrum, and to keep powering recovery in cyclical and reflation trades. If disappointment that the Fed didn't do more triggers a correction, we think it will be buyable -- the very fact of the correction will force the Fed to do more.

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increasing only "gradually." For output and hiring it's worse -- they have gone from "improving gradually" to "slowed in recent months."

Deflation was not mentioned by name -- it never is in FOMC statements. But hints about the committee's concern with it, begun at the previous meeting (see "On the June FOMC" June 23, 2010), were amplified today, if indirectly. As at the previous meeting, inflation was said to have "trended lower" -- but this time the excuse that prices of "energy and other commodities have declined somewhat" has been removed.

This is all broadly as expected, supporting our view that the "expansionless recovery" will continue to trudge along. There won't be the "V-shaped recovery" markets expected earlier this year, but at least the odds of a "double-dip" recession were substantially lowered today. Even without dramatic action, the FOMC signaled today that the Fed is unlikely to repeat its errors of 1936-1937, and tighten before sustainable expansion has taken hold (see our *Wall Street Journal* op-ed, "Why This Isn't Like 1938 -- At Least Not Yet" July 9, 2010).

Bottom line

Today's FOMC took something more than a baby step toward easing, which helps alleviate the risk of a 1937-8 policy error of premature tightening. But fell short of the ideal move of making the "extended period" explicit, a missed opportunity to alleviate the crippling policy uncertainty holding back growth. The "expansionless recovery" will continue, and the Fed will likely be pressed to more easing later this year. The Fed's modest action today is enough to keep rates low across the curve and down the quality spectrum, and to keep powering recovery in cyclical and reflation trades. If disappointment that the Fed didn't do more triggers a correction, we think it will be buyable -- the very fact of the correction will force the Fed to do more.

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