TrendMacrolytics

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FED SHADOW

Awaiting Greenspan

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Expect **Fed Chairman Alan Greenspan** to walk an exceedingly cautious line tomorrow when he motors up to Capitol Hill for his semi-annual policy testimony. Deciphering Greenspan's oracular pronouncements on these occasions is often an exercise in sifting through layers of finely ground minutiae, and tomorrow is likely to prove no different. As an investment opportunity, however, the hearing could pay off for those positioned to take advantage of the scaling-back of expectations that the Fed soon will move aggressively to reverse last year's rate cuts. Euro-dollar futures are still priced for as much as 125 basis points in funds rate hikes by year-end. Although these rate-hike expectations have receded from near-200-basis-point levels toward the end of last year, they still appear to remain significantly overdone. At this point, our best bet is that the funds rate will remain at 1.75% for the duration of this year.

To be sure, it probably can be safely assumed that Greenspan will not dwell heavily tomorrow on remaining downside risks to the economy's prospects for emerging from recession. No doubt he has been somewhat chastened by last month's experience, when he was forced to "correct" a downbeat evaluation of the economic outlook when it was widely interpreted as presaging another rate cut. Our assessment at that time was – and remains -- that Greenspan's initial remarks reflected his real view, but that he changed tack after hearing from several regional reserve bank presidents none too happy to have the chairman front-run the forthcoming **FOMC** decision. As it turned out, that late-January FOMC meeting was the first in the past year that produced no rate cut. At tomorrow's hearing, he will be testifying formally on behalf of the full panel, so his prepared remarks will be even more carefully couched than usual.

Nevertheless, any one holding out hope that the Fed chief will paint a blue-skies portrait of an economy on the cusp of vibrant recovery likely will be severely disappointed. While various indicators continue to show signs of a bottoming, with a modest upswing in certain sectors, Greenspan has emphasized repeatedly that this has primarily been a business-investment-led downturn. That means a return to sustainable, productivity-based expansion is going to take more than a braking of the collapse in capital investment or a deceleration in record levels of inventory liquidation. It will require a recovery in capital goods investment, particularly in high-tech sectors, indications of which remain sparse at best. The survey released yesterday by **G7 Group Inc.** showing a continued contraction of capital spending likely did not escape Greenspan's attention.

Our analysis has been that the depression in capital investment has been part and parcel of the Fed's deflationary policy error. By reducing expected returns and raising the risk premium in the cost of capital, Fed policy raised the hurdle rate justifying new investment to prohibitive levels. But although it is unlikely to be addressed at tomorrow's session on Capitol Hill, we continue to see early evidence of relief from a deflationary scarcity of dollar liquidity. Although gold has shown considerable volatility, the price has remained above $290 since early this month, up from the sub-$280 ranges that had prevailed for most of the past two years. Broader commodity indexes, at the same time, continue to show steady, if modest, rates of recovery from their most depressed levels late year. TM

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