TrendMacrolytics

Donald Luskin, Chief Investment Officer
David Gitlitz, Chief Economist

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Help is on the Way?

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David Gitlitz

The market's betting that the FOMC will cut rates next week. Here's why the market isn't more thrilled about that.

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It might be tempting to hope that the last obstacle to a resumption of vibrant economic expansion would be cleared away with another 25 or 50 basis point cut in **the Fed's** overnight target rate. If that were the case, though, the rampant speculation that the Fed is now poised to lower rates again when the **FOMC** meets next week would likely have been more warmly received by the equity market. But after powering some 15% higher in the eight sessions following the lows of October 10, the broad equity indexes have been treading water since the beginning of last week. That's when we noted that there still appeared to be considerable resistance to capturing the bulk of the risk premium remaining in financial asset prices, and suggested that the "easiest part of this rally may be nearing its end" (see "Resistance" October 21, 2002).

That premium is a measure of the uncertainties continuing to dog the economic outlook -- the lingering risk of monetary deflation prominent among them. We have described how the Fed's rate-targeting mechanism is a crude tool for battling such risks. For example, by opening the door to a possible rate cut last month, the FOMC actually set in motion short-run dynamics that resulted in a reduced pace of liquidity additions. The Fed's marginally tighter open-market stance was indicated by the $10 decline of the gold price following last month's FOMC meeting (see "Monetary Hall of Mirrors" October 11, 2002). Should the FOMC next week confirm expectations of a rate cut, those tightening influences should unwind to some degree, as economic activity that had been delayed while awaiting a further drop in short term rates is undertaken. To the extent such activity drives a faster pace of credit creation, it would also tend to boost reserve demand, which the Fed would be compelled to accommodate to defend the new rate target. Then again, should next week bring no action other than signaling that the funds rate could be dropped at December's meeting a month hence, the Fed's more restrictive posture could be extended.

Such are the inefficiencies and distortions inherent in the Fed's flawed operating mechanism. By contrast, under a price-rule approach the Fed would the let the funds rate float and act directly to stabilize a representative sample of market prices with the highest monetary content -- foreign exchange, gold and other sensitive commodities. At this point, the institutional obstacles to implementation of such a regime are -- for all practical purposes -- insurmountable.

But until the Fed adopts a price-rule approach, monetary policy will be an exercise in trying to pilot the speedboat from the water-skis. That means there will be dangerous and costly time-lags between Fed policy actions and confirmation by the universe of prices that those actions have had the intended effect.

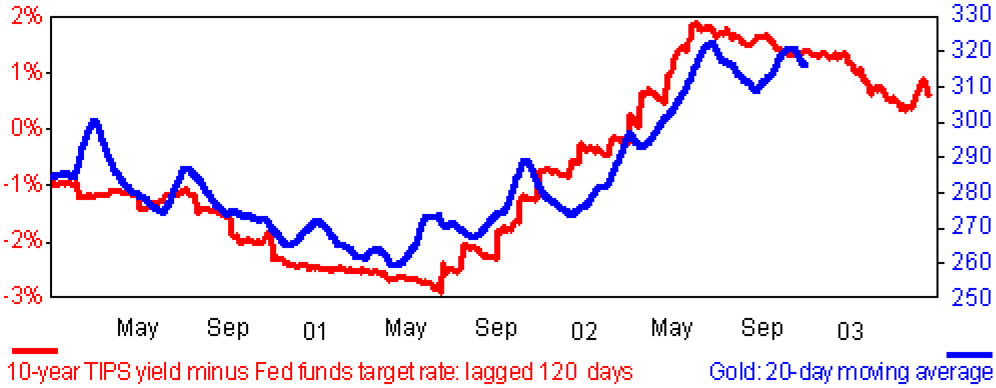
http://www.trendmacro.com
don@trendmacro.com
dgitlitz@trendmacro.com

325M Sharon Park Drive #325
Menlo Park CA 94025
Phone 650 429 2112
Fax 650 429 2112

42 Forest Drive
Parsippany NJ 07054
Phone 973 335 5079
Fax 973 402 5074

The chart below demonstrates what we mean. It plots the difference between 10-year inflation-indexed Treasuries (TIPS) and the fed funds rate target against a 20-day moving average of the daily gold price. While by no means perfect, the TIPS yield provides a useful analytical proxy for real returns available in the economy. In the Wicksellian model of monetary policy, the central bank sets its target overnight rate relative to available returns -- to the extent available returns exceed the target rate, the Fed creates an incentive for new borrowing, and liquidity is created when the Fed supplies the reserves to underpin that borrowing. At the same time, the availability of higher returns relative to those on risk-free cash balances also reduces the demand for money as an investment asset. In moving from a deflation during which the funds rate was kept above the real rate of return for an extended period of time, getting the spread "right" works on both supply and demand to rebalance the excess scarcity of money.

Why lag when you could lead?
Targeting the funds rate moves the universe of prices, but only after a dangerous and costly delay



But how does the central bank know what is the "right" spread between available returns and the overnight target? The chart shows that it doesn't -- at least not without a significant lag. Regression analysis shows that changes in the TIPS/funds spread explain nearly 90% of subsequent gold price changes, *but only after a 120-day (24-week) lag*. In other words, whatever policy changes might be instituted next week likely won't be proven "right" or "wrong" even in the most sensitive monetary indicators for nearly six months! That kind of lag is evidence of the inefficiencies in the Fed's operating approach, which is especially vulnerable to perverse outcomes during periods of changing policy expectations. Eventually, it seems, these short-run incongruities are overcome by the larger fundamental forces at work, but delay obviously gives rise to increased uncertainty and is economically costly in itself.

Moreover, the real-return component of the relationship is hardly a purely independent variable free from Fed influence and changing expectations of Fed action. Beginning last spring, for example, as super-V recovery prospects collapsed along with stock prices, so did Fed rate-hiking expectations and TIPS yields, which fell from 3.4% last April to 2.1% earlier this month. Over the same period, year-on-year growth of Fed balance sheet assets fell from about 10.5% to just above 7%. Thus, under the rigidities of its operating regime, the Fed is effectively compelled to adopt a less generous posture *as expectations of future tightening recede.* The chart indicates that this likely will be reflected in a further moderate decline of the gold price in the weeks ahead. That, in turn, is likely to sustain the deflation risk environment for some time to come, notwithstanding the longer-term mitigating effects of whatever action might be taken next week.