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FED SHADOW

Good News, Bad News

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The Fed takes a step in the direction of sanity -- if only a small one.

Tuesday we suggested that the inevitability of **the Fed** coming to terms with "economic reality within the rationalization for its increasingly unreal policy stance" meant that the props supporting its super-easy posture "could give way significantly sooner" than estimated by consensus expectations (see "Don't Worry, Be Happy?" January 27, 2004). Sure enough, with its nuanced adjustment in yesterday's post-meeting announcement, the Fed has done just that: bowed to economic reality while pledging to remain "patient in removing its policy accommodation," and in the process blind-siding those who insisted that the Fed would maintain a 1% funds rate as far as the eye can see.

We see this as a good news/bad news story, the net effect being marginally less risk that the Fed will blindly blunder into severe inflationary error, but nevertheless allowing ample scope to maintain its excess liquidity stance for a still-indefinite period. Essentially, the central bank has begun the process of wriggling out of the corner it painted itself into last summer with the ill-advised commitment to maintain its highly accommodative stance for a "considerable period." However, it's only the start of that process, and barring some currently unforeseeable event, it's likely that the Fed will approach the policy shift in the deliberate, methodical fashion that has been the mark of **Alan Greenspan's** tenure.

Indeed, it's entirely possible that yesterday's statement reflects no real change in Greenspan's own thinking about the timing of the first rate hikes, but was put out primarily to alert complacent markets that the move would likely come sooner than they were priced for. Greenspan himself used exactly the same language about the Fed being "patient" in removing its policy accommodation in a November speech. Our best bet at this point is that the first hike will come no later than the late June **FOMC** session, and possibly as soon as the early May meeting, with a follow-up move in early August. In an election year, that schedule would allow Greenspan to complete an opening round of policy adjustments early enough to avoid having the Fed become a campaign issue.

In the meantime, however, the Fed remains in ultra-easy mode, and the bottom line is that it did nothing yesterday to keep the inflationary impulses resulting from targeting a 1% overnight rate from continuing to build. It's also the case that from any objective perspective, the Fed will remain highly accommodative even after it begins lifting rates. And as discussed in Tuesday's report, maintaining a below-equilibrium target as market forces push up on rates is the functional equivalent of further easing policy. With market expectations now pricing for a higher likelihood of out-month rate hikes, those pressures on the overnight market rate will also mount, meaning that the Fed will actually be falling further behind the curve as it ostensibly moves closer to raising rates.

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Given that, the dollar's abrupt strengthening seen in gold and forex markets in response to the Fed statement would seem counterintuitive. As a first-blush response, however, it's not so baffling. If the dollar's lows seen over the past few weeks represented a bet on a worst-case inflationary outcome, the revised policy perspective at least makes that eventuality less likely. At the same time, though, we'd be cautious about making any bets on the sustainability of the moves seen since release of yesterday's announcement. Most likely, these markets will continue to be marked by high volatility reflecting the uncertainty still surrounding the policy outlook.

Meanwhile, it seems that the days are clearly numbered for the free-lunch carry trade in the bond market, and the 10-year Treasury yield backup to around 4.2% from the levels below 3.95% seen just a week ago is probably just a start. Although we've had our ups and downs with our **Model Position short the 10-year** since putting it on last year, with it now showing a loss of 3.8%, we are reaffirming the position today, and believe the fundamentals are now more favorably aligned for that trade than they have ever been.

At the same time, through all the waves of speculation that the Fed was extremely unlikely to raise rates by mid-year, if ever, we have stuck by our **Model Position short June 2004 Eurodollar futures**. However, with the contract now fully priced for one 25 bp rate hike, after showing chances of less than 50% just last week, we are closing the position, booking a profit of 0.3%. TM