TrendMacrolytics

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Neither Rain Nor Gloom

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Bond markets are only beginning to see that the Fed's normalization course will not be deterred.

With the track of **Hurricane Rita** apparently veering away from a worst-case landfall in terms of potential **energy supply disruptions**, **gold** prices today are for the first time reflecting the diligence signaled by **the Fed** at this week's **FOMC** meeting. We couldn't have asked for much more than the Fed delivered Tuesday. Despite its "tragic toll," the economic fallout from **Hurricane Katrina** does not pose a "persistent threat" to the **expansion**, the Fed asserted, thereby refuting suggestions that the pall of Katrina would compel it to alter course. Against the backdrop of a **still-accommodative posture**, the Fed recognized that "higher energy and other costs have the potential to add to inflation pressures," and reiterated its intention to move toward **policy neutrality** at a **"measured"** pace. Despite the lone dissent of **Fed Governor Mark Olson** to the **funds rate target** being lifted again to 3.75%, the Fed offered very little -- if any -- sign that an early end to the **rate normalization cycle** is in sight.

Release of the FOMC statement, however, was almost immediately supplanted in significance by the intensification of Rita as it steamed west toward the **Texas Gulf Coast** with its heavy concentration of **oil refineries**. Amid the renewed surge in energy prices, **interest rate futures** and **bonds** rallied on rekindled hopes that this might finally do the trick and at least put the Fed on hold. But the **inflationary** risk implied by that potential policy outcome was laid bare yesterday when the gold price spiked to the $475 level for the first time in nearly 18 years.

That risk having now subsided along with the worst-case scenarios of hurricane damage, gold today is falling back toward $460 and bonds are again reversing gains built on weather-induced wishful thinking, with the **10-year yield** bouncing back up to the 4.25% range of earlier this week. Nevertheless, market expectations remain badly misaligned with what we see as the most likely policy course going forward, reinforced by Tuesday's FOMC statement. Prior to the Fed session, January **fed funds futures** closed Monday priced for a 4% year-end funds rate. Following the meeting Tuesday, the implied yield bumped up to 4.07%, indicating a 28% chance that the rate would close the year at 4.25% rather than 4%. After falling back the past two days in accord with the Rita play, the yield today is back at Tuesday's levels.

From our perspective, it's difficult to discern how any objective reading of the Fed statement can lead to a conclusion that the 25 basis-point-per-meeting rate-normalization course is likely to be interrupted before year-end, putting the target at 4.25%. It's interesting, though, that the biggest sell-off in futures today is coming in the **June '06 Eurodollar contract**, which is down by 7.5 bps. At current prices, it is showing about a 50/50 chance of a 4.25% target by mid-year, which still seems a significant undershoot. Our baseline assumption at this point is that the Fed will effect at least one more **rate hike** in the New Year beyond the 4.25% level that will prevail at the end of this year. The sharp downturn in the June contract is an indication, however, that the

market is at least beginning to go through the process of catching up with reality, although it still has a long way to go.

Bottom Line: The worst-case scenario for additional energy supply disruptions arising from Hurricane Rita also implied a worst-case inflation outlook resulting from the Fed accommodating the consequent energy price spike, as seen in the gold price rallying to the $475 level. The pricing out of those risks can be seen today across the energy, fixed income and precious metals markets. As has been the case throughout this rate-normalization process, however, market expectations are still well behind the curve of the Fed's most likely course. TM