TrendMacrolytics

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FED SHADOW

Fed Marking Time

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The FOMC fiddles while inflation burns -- and bonds applaud.

Bonds ticked higher on relief that the FOMC didn't overtly shift to a more hawkish footing, but neither did yesterday's statement give any succor to the persistence of wishful thinking that the Fed is poised to begin cutting rates sometime soon. While the determinedly stand-pat stance puts the still accommodative central bank another notch further behind the curve, the FOMC is also continuing to warn that inflation risks remain, and essentially is diagramming the process under which its hopes to remain on hold will likely be forced to give way to recognition that further action is needed.

In part due to a "cooling" of the housing market, "economic growth has slowed over the past year," and "going forward the economy seems likely to expand at a moderate pace," the statement said. It's clear that the Fed has a lot riding on that perceived slowing, as it notes that "readings on core inflation have been elevated, and the high level of resource utilization has the potential to sustain inflation pressures." From the Fed's flawed neo-Keynesian perspective, the continued moderation of growth is a prerequisite to relieving those "resource" pressures and putting "elevated" inflation back under wraps. "Inflation pressures seem likely to moderate over time," according to the FOMC, "reflecting reduced impetus from energy prices, contained inflation expectations, and the cumulative effects of monetary policy actions and other factors restraining aggregate demand."

Update to strategic view
FED FUNDS: While the Fed marks time on pause, inflation pressures continue to build -- necessitating an eventual return to rate hikes. We see better than 50/50 probability of a hike as soon as the December FOMC meeting. **US BONDS:** The long end of the Treasury curve has mistaken the bureaucratic formality of an essentially contentless FOMC statement as a marginal affirmation of the Fed's dovishness. We expect the Fed will quickly find other contexts in which to continue to condition the bond market to abandon its hopes for rate cuts. The rise in yields of the last several weeks should continue.
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Fact is, though, we can find little confirmation for the Fed's growth outlook in indicators of risk preference and capital formation, which suggest capital continues to be put at risk to capture still robust available returns. This is the process which creates healthy rates of economic expansion. Besides, whether or not growth slows as much as the Fed expects, core inflation will continue to push higher -- a product of the Fed's long-standing excessively easy posture. In the weeks and months ahead, it will become clear that the Fed doesn't have a leg to stand on in its rationale for remaining on hold, auguring a return to rate-hiking mode.

BOTTOM LINE: Another stand-pat FOMC meeting provides another opportunity for the Fed to be misread. Credit markets clinging to the notion of the Fed going into rate-cutting mode actually upped that bet yesterday, despite the complete absence of any support for that proposition in the FOMC's statement -- and the fact that the Bernanke Fed has consistently treated these statements to a large extent as bureaucratic formalities, using other opportunities

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to try to communicate its agenda in more depth and precision. While even the Fed's present stand-pat stance is less already far less dovish than the bond market believes, we see the sustainability of that stance as conditional on highly doubtful forecasts for slowing growth and inflation being borne out. We continue to see that as unlikely, and believe it's only a matter of time before it becomes evident that the Fed's next move will be to re-enter rate-hiking mode. TM