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FED SHADOW

On Second Thought…

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After Wednesday's knee-jerk reaction to the FOMC statement, a clearer appraisal.

Since mounting a knee-jerk rally late Wednesday in the wake of the FOMC statement -- on the supposition that the Fed was signaling it is now amenable to the possibility of rate cuts -- bond bulls have been licking their wounds, as a more clear-eyed reading suggests the statement represented no real shift in the policy outlook (see "Huh?" March 22, 2007). This reappraisal has now snapped the 10-year Treasury yield back to 4.6%, a level last seen late last month, nearly 10 basis points above Wednesday's best levels. The 2-year note, at 4.59%, is holding on to slight gains relative to pre-FOMC levels, but has reversed the bulk of the rally that pulled the yield down to around 4.5% at its peak.

Update to strategic view
US BONDS: In the short run, we expect somewhat of an inversion to return to the yield curve, as short maturities will be most sensitive to the realization that rate cuts are not an imminent prospect. Longer term, we anticipate a significant curve steepening, led by a sizeable repricing at the long end, as it becomes clear that the prospect of any Fed rate cutting is out of the realm of possibility.
[see Investment Strategy Dashboard]

The initial excitement generated by the Fed statement was primarily due to removal of the language positing the possibility of "additional firming" that has appeared in each FOMC announcement since the Fed went on pause last August. This was replaced with the seemingly more neutral declaration that "future policy adjustments will depend on the evolution of the outlook for both inflation and economic growth, as implied by incoming information." Ostensibly, this would appear to indicate that the Fed is now no more inclined to raise rates than to cut them, and that was enough to light the fuse under the financial markets Wednesday.

In the full context of the statement, however, that would be a misreading. At the same time as it was eliminating the reference to "additional firming," the Fed also indicated in no uncertain terms that its inflation concerns are growing. "Recent readings on core inflation have been elevated," the statement read, contrasting with the previous post-meeting statement in late January, when the Fed said that "readings on core inflation have improved modestly in recent months." While maintaining its boilerplate assurance that "inflation pressures seem likely to moderate over time," the Fed also repeated the familiar caution that "the high level of resource utilization has the potential to sustain those pressures." Then, it added *an entirely new warning* which left no doubt about its cognizance of inflation risk: "In these circumstances, the Committee's predominant policy concern remains the risk that inflation will fail to moderate as

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expected." In other words, unless core inflation breaks below its current trends -- the prospect of which we see as highly unlikely -- the Fed inevitably will be compelled to resume raising rates.

Admittedly, given all that, why the panel chose to remove the "additional firming" language is somewhat puzzling. It would seem to suggest that at this point conveying a consistent message of vigilance is not necessarily the policymakers' sole priority. While the statement did not mention the subprime mortgage meltdown, the market angst precipitated by the crisis assuredly was a topic of considerable pondering in the Fed's boardroom this week. But specifically identifying the subprime implosion could have implied that the breakdown represented a greater degree of economic risk than the Fed wanted to convey. At the same time, however, there likely was considerable sentiment among the panel to at least avoid further exacerbating the problem. Removing the specific reference to the possibility of additional rate hikes might have seemed like a low-cost way to help calm market fears without giving up much policy flexibility.

Ultimately, the cost of such a compromise of policy priorities will be measured in the extent to which it allows inflation to continue ticking higher. In the final analysis, such message- tailoring by the Fed probably only further delays its inevitable return to rate-hiking. Given that policy is already in an accommodative, excess-liquidity posture, such delay is not inconsequential. Essentially, it means that the Fed is prepared to tolerate somewhat higher inflation in the short term as the price to be paid for its forbearance. Ultimately, however, it also implies that the Fed will have to do more to restore monetary equilibrium when it finally resumes the tightening process.

BOTTOM LINE: The most that can be said in the wake of the Fed's latest policy statement is that policymakers probably are content to extend their pause somewhat while the latest market panic plays out. But contrary to any notion that the Fed has become less inflation-conscious, this policy message reflected growing intolerance of the threat to dollar purchasing power. While fixed income markets have come well off their best levels of Wednesday in recognition that the initial knee-jerk reaction was a misreading, they remain nearly fully priced for two Fed rate cuts this year. In the recent rally, in fact, the strength of that conviction could be seen in the fact that the best performing asset was the 2-year note at the short end of the curve, which fully absorbed an inversion relative to the 10-year Treasury which stood at about 14 bps less than a month ago. In the short run, we'd expect to see somewhat of an inversion to return to the yield curve, as short maturities will be most sensitive to the realization that rate cuts are in no way an imminent prospect. Further out, though, we anticipate a significant curve steepening, led by a sizeable repricing at the long end, as it becomes clear that the prospect of any Fed rate cutting is out of the realm of possibility.