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FED SHADOW

This is the Turn

Wednesday, June 11, 2008
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In a matter of days, Fed expectations have shifted 180 degrees -- to the right direction.

The Fed expectations environment is undergoing a remarkable transformation in the direction we have anticipated, and even quicker than we expected. We have been nearly alone in seeing the Fed aggressively moving this year to reverse the 325 bp in rate cuts made since last September (see "Facing the Music" May 29, 2008). But the extent to which Fed officials, led by chairman Ben Bernanke, have been alerting the markets to their inflation concerns suggests an urgency that hadn't previously been obvious.

Update to strategic view
FED FUNDS: Futures markets have dramatically moved toward our view that the first rate hike will be at the August FOMC meeting. We see the sudden change in expectations as a durable inflection point, and now expect as much as100 bp in hikes by year-end.
[see Investment Strategy Dashboard]

The results have been eye-popping. The past two days, the 2-year Treasury note yield soared by more than 50 bp, to 2.92%, the largest two-day spike in more than 20 years. Fed funds futures, which late last week were showing a 50% chance of a first rate hike coming by the October FOMC meeting, are now priced for better than 100% probability of the first hike coming in September, with about a 50% chance for a move in August. Further out, the curve is well on its way to pricing for a funds rate of 3.25% by next April; last week it was fully priced for hikes of only about 50 bp from the current 2% target. Today's trading is seeing a very modest reversal of this new rate-hiking bet. But we expect that to be a fairly brief respite with forces coalescing, if anything, to move expectations in an even more hawkish direction going forward.

In assessing what amounts to a nearly 180-degree turn in the Fed's professed appraisal of inflation risk -- from utter complacency to mounting worry -- we are compelled to ask, "Why now?" It appears that a big part of the answer has been the erosion in inflation expectations revealed in recent surveys. All during its easing exercise, the Fed clung to the notion that the aggressive course of rate cutting was not inflationary because expectations remained "well anchored." We have seen this as a fundamentally flawed concept because, as the Fed itself has acknowledged, expectations tend to lag actual reported inflation, which suggests their forward-looking properties are highly limited, at best (see "The Bernanke Awakening" June 5, 2008). But the important point is that for the Fed itself, expectations survey results have a central place in the policy framework, and they cannot credibly ignore those results when they take an unfavorable turn (again, see "Facing the Music").

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The hawkish turn in Bernanke's rhetoric has come since the University of Michigan consumer sentiment survey last month showed a continued uptrend in both one-year and five-year inflation expectations. One-year expectations last month were 5.2%, their highest since 1982, and showing a steady uptrend since registering at 3.1% last October. Five-year expectations were 3.4%, a 13-year high and up from 2.8% last October. In his speech last week acknowledging the inflationary implications of dollar weakness, Bernanke cited "the risk of an erosion in longer-term inflation expectations." And on Monday, the Fed chief said the central bank "will strongly resist an erosion in longer-term expectations, as an unanchoring of those expectations would be destabilizing for growth as well as for inflation."

In the speech on Monday, Bernanke also asserted that "the risk that the economy has entered a substantial downturn appears to have diminished over the past month or so," suggesting that the near to medium term economic outlook probably pose less of an obstacle to initiation of a rate normalization process than it has until recently. And for the first time, he also cited the Fed's liquidity facilities instituted during the credit crisis to help restore market stability as key to the prospects for growth. "One of the most effective means by which the Federal Reserve can help to restore moderate growth over time and to reduce the associated downside risks is by supporting the return of financial markets to more-normal functioning," he said. This indicates a belated acknowledgment ofa key policy dimension that we have been emphasizing since the Bear Stearns crisis in March -- that with these facilities providing the needed liquidity backstop to maintain market stability, waning risk abhorrence will help support growth, and the Fed will be less constrained to take action to begin restoring monetary equilibrium (see "2 + 2 = 3 and 3 - 2 = 2" April 7, 2008).

While Fed policy expectations have taken a dramatic turn, there remains a strain of skepticism in the markets and among analysts that policymakers will actually be prepared to follow through, at least in the timeframe now foreseen by the markets. We can appreciate such reservations, and know it can be costly to take the Fed at its word - or, inevitably, at its hint. But our instincts are that on this occasion Bernanke and his colleagues would have far more to lose than to gain if their recent statements turned out to be empty rhetoric. The Fed's inflation-fighting credentials have been seriously challenged by the easy-money campaign undertaken in response to the financial market turmoil. Bernanke understands this would be a highly inopportune time to be making statements that he doesn't intend to deliver on.

BOTTOM LINE: Market's have undergone a neck-snapping transformation in their Fed policy outlook, as senior Fed officials have adopted a much more hawkish line in their public statements. We see this as a genuine shift in the Fed's perspective, driven primarily by the unanchoring of what policymakers had long portrayed as "well anchored inflation expectations." While funds rate expectations have already shifted higher, with the hikes expected to begin sooner, additional movement along the same lines seems likely, fully pricing for the first hike by the August FOMC session, with as much as 100 bps in hikes before year end.