



## Reviewing the Options: Measuring the Fed

Reviewing the options, we quote a bit from the trade's commentary this morning and then offer our own.

From CSFB this morning

"Activity overnight was very quiet with Tokyo closed for a holiday for the next couple of days. Futures volume was about half of average as the market focuses on the language of the FOMC statement due out this afternoon. Flows during US hours continue to be biased toward flatteners although we have seen some profit taking on these positions.

A 25 bp rate hike is widely expected at today's FOMC meeting. The choice for the Fed seems to be either no change in the statement, or dropping measured and introducing growth concerns. Curve flattening wins hands down in the former, in our view. It may be okay in the latter, depending on how the growth concerns are presented. We marginally favor no change. Risk reward favors flattening. We continue to favor buying on dips with support in 10s around 4.20% to 4.22%."

And from Bloomberg, quoting Richard Berner, Chief Domestic Economist at Morgan Stanley,

"I believe that the current economic deceleration is temporary, as energy prices are now stabilizing or declining, pent-up demand for capital spending and hiring is still substantial, and there are encouraging signs that the demand for durables is stabilizing. Against that backdrop, inflation risks continue to rise.

A muddle-through scenario seems to be in the price. In contrast, my scenario implies a bearish flattening of the yield curve. Under the Fed's forecast, long-term yields might stabilize sooner. A more stagflationary outcome would involve a steeper yield curve."

Markets need to focus on three points today and then, after the Fed announcement at 2:15pm today, on how to interpret future the policy alternatives that the Fed will suggest (perhaps by implication) in light of emerging data.

1) Stag-flationism: Is the evident slowing of domestic economic growth sufficient to retard or reduce the currently experienced uptick in inflation (particularly over the last 12 months)? Those who think the real Federal Funds rate is far too low believe that there are strong incentives for spenders to be self-indulgent and that various pockets of inflationary pressure will be encouraged by such a low, real rate structure. In effect, they would argue monetary policy is far too accommodative. If you believe that then you would have to argue that the FOMC must either delete the "measured" language of prior statements and put the market on notice that the Fed will pursue a much more aggressive anti-inflationary stance in the immediate future. Berner argues that this would mean a steepening of the curve, and we agree. Further to this thought, we believe that in the context of energy prices and their sustained high levels (even if they have moderated slightly in recent weeks), there is continuing risk that energy prices can continue to rise. Note, we say that is a risk, not a forecast. But in the Fed's risk-management context (the



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Chairman's favored métier), it would behoove the Fed to put the market on a higher degree of alert. The Fed does not want to be accused of falling victim to the Burns' error of the 1970's and continue a monetary environment that supports rising energy prices by excessive demand stimulation. It might even be argued that the Fed could justify an even stronger case by "surprising" the market with a less than "measured" response today by raising the Funds target more than 25 basis points. The problem with that strategy ---even if sound from the standpoint of telling the market that the Fed's hierarchy shows anti-inflation measures first and growth second, is that "surprise" is not a preferred Fed tactic anymore. That said, leaving "measured" in the Statement cannot help but alarm those who feel that monetary policy still is far too accommodative.

**Inflation versus Growth:** In the long run, contra Keynes, we are not "dead." There is no real choice open to monetary authorities as between inflation and growth and they should so state. The Fed knows that, but it is also a political institution much as purists wish it were not. A stronger statement contains a risk that markets could understand the Fed to be less concerned with growth and willing to suffer some erosion in employment growth in order to mark 'paid' to its anti-inflation stamp. Such a stance will encourage the Congressional Clown Caucus to scream at the Fed's policy officials that the already overstretched middle income groups that they think they represent will be paying the price of rising prices with less employment income. Fairness is in the eyes of the Officeholder. That is always the case when the punch bowl disappears and the Fed tells the party go-ers to go home. However, embedded in any posture by the Fed toward a tougher statement today is also an implied view on a second half rebound. Markets could be led to believe that the Fed feels comfortable that growth in 2H2005 will be fine. In our view, risk management considerations suggest that a stronger statement would be better on both counts: retarding inflation and encouraging optimism. The question for the Fed is whether it believes its own forecasts. Second, does it think that markets will get the right message if it a bit less restrained. The answer should be to make clear what message the FOMC wishes to send! What they really think, only they know.

**Imbalances:** Much has been made of the housing boom, the current incentives for consumers to spend and not save, the burgeoning twin deficit, albeit they might not be a consequence of one another. The latest volley aimed at the Fed was Ted Truman in yesterday's FT. Truman feels the Fed has larger (social?) responsibilities and ought to tune its monetary policy to reducing "absorption," implying, thereby, that the Fed can distinguish between demand reduction and output reduction. We don't subscribe to that view, however laudable such a world might be. One is never sure when the subject of insufficient saving comes up why it is that excessive spending is worse than excessive saving. If the U.S. has a current account imbalance, other countries have excessive saving. The argument for the Fed directing its attention to 'worldly concerns' is one that hinges on an asserted "risk" of a financial infarct that can arise in the future if suddenly policy authorities in other countries (principally Asia) suddenly take a dim view of their holdings of U.S. Treasuries. We don't think it is likely that such a Prisoner's Dilemma will be suddenly resolved by Asian central bankers suddenly shooting their own economies in the foot. It was weak footedness that led them into this trap in the first place. 'Fessing-up' is what the other guy is supposed to do,' reminiscent of General Patton's encouragement of the troops on D-Day to 'make the other guy die for his country.'

At the end of this day, the Fed is likely to stay with the Measured, hoping like a baseball manager with an unsteady Bullpen that he can leave his starting pitcher one more inning. Sometimes it works...and sometimes the manager gets second-guessed. We think its time to pull that pitcher, but we're in the bleachers and the manager can't hear our call from the stands!