

IS THERE A SPLIT AT THE FOMC?

One of the most puzzling aspects about the current correction is the stance of the FOMC. What does it really believe about the economy? Each day, one reads a succession of relatively optimistic assessments by various Federal District Bank Presidents that seem to suggest that growth is just around the corner (or at least will resume in the second half). Similarly, 2002 looks to be a 3-4% growth year. But, the 'slash and burn' of corporate earnings and negative pre-announcements suggests that investment spending could fail to ignite quickly in the current environment. The increasingly dismal corporate view is also held by certain Wall Street economists who view **recession** as a strongly, probable event. The latter clearly have an elongated "U" in their recovery forecasts with the main focus on the extent of the "bottom." Today's employment report will intensify that feeling. The few reports that suggest a slowing of the rate of decline on the industrial, clearly do not suggest a near term recovery.

The issue now is how to resolve the apparent contradiction between optimistic statements by various members of the FOMC and the pessimistic views of a prolonged contraction. One area of difference is the respective view on Investment spending. If you parse the last FOMC statement, you can infer two, distinctively different, views on the source of the downturn and its probable length.

"Inventory correction view?"

Persistent pressures on profit margins are restraining investment spending and, through declines in equity wealth, consumption. The associated backup in inventories has induced a rapid response in manufacturing output and, with spending having firmed a bit since last year, inventory adjustment appears to be well underway.

"What Greenspan worries about?"

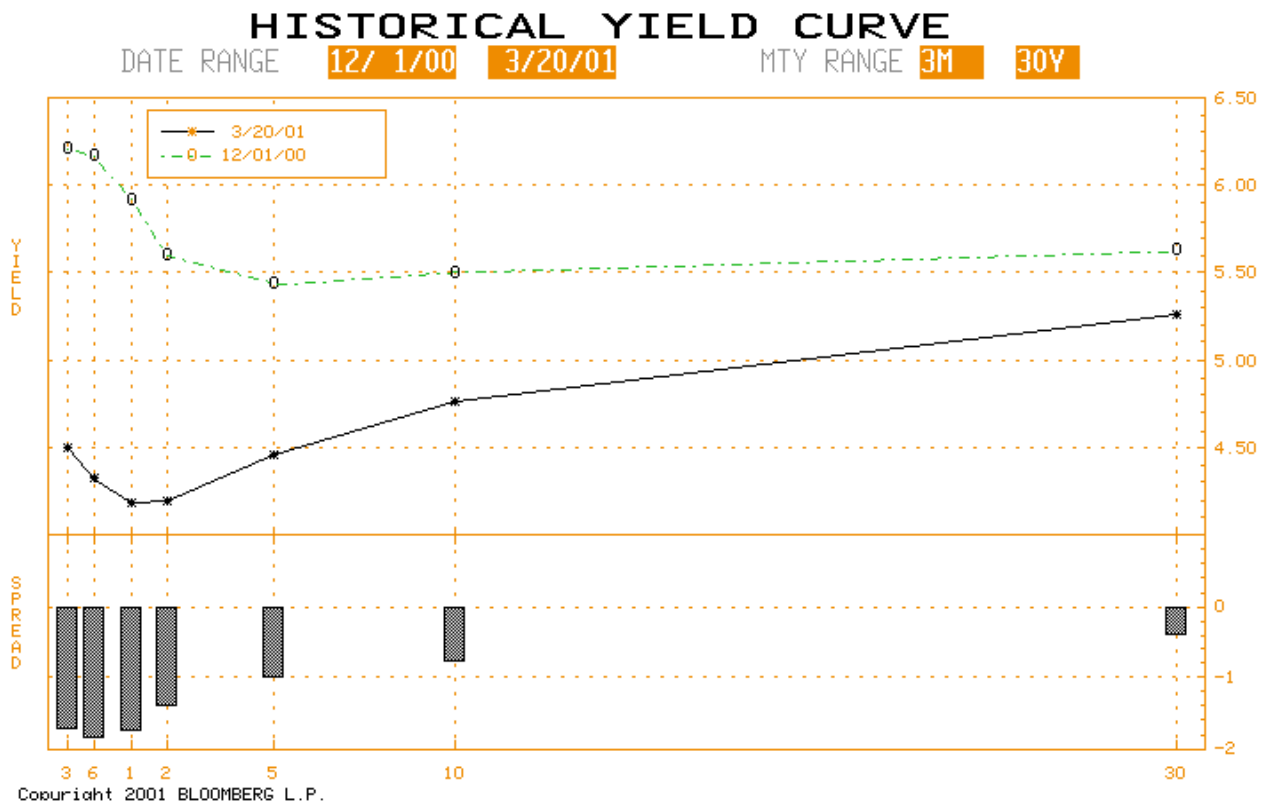
"Although current developments do not appear to have materially diminished the prospects for long-term growth in productivity, excess productive capacity has emerged recently. *The possibility that this excess could continue for some time and the potential for weakness in global economic conditions suggest substantial risks that demand and production could remain soft. In these circumstances, when the economic situation could be evolving rapidly, the Federal Reserve will need to monitor developments closely.*" *(emphasis added)*

The first paragraph is the classic "V" model: **inventory adjustment**. The second paragraph raises the more ominous note that an **excessively large capital stock** could trouble the economy for some time. It also stands in sharp contrast to recent Federal District Bank President speeches that speak of recovery just around the corner. Makes you wonder how they got to unanimity on the 50 basis point reduction.

The capital stock adjustment problem is more than a bit troubling. If, as now seems probable, the 1998/1999/Q12000 period of exuberant investment was built on the belief that a much higher aggregate growth rate was possible and that New Economy Companies would grow at rates of 30/40/50%, the capital stock adjustment process could be quite drawn out. The optimal capital stock was influenced by high, expected growth rates for sales and ultimately earnings, and also by “zero-cost” capital. This raises the question of whether monetary policy can be effective in the short term in reviving investment spending? Despite the fact that some economists in the past have claimed that interest rate reductions won't get the job done when the economy is troubled by excessive capacity, this Fed (particularly under Greenspan) has believed in its ability to 'manage' growth.

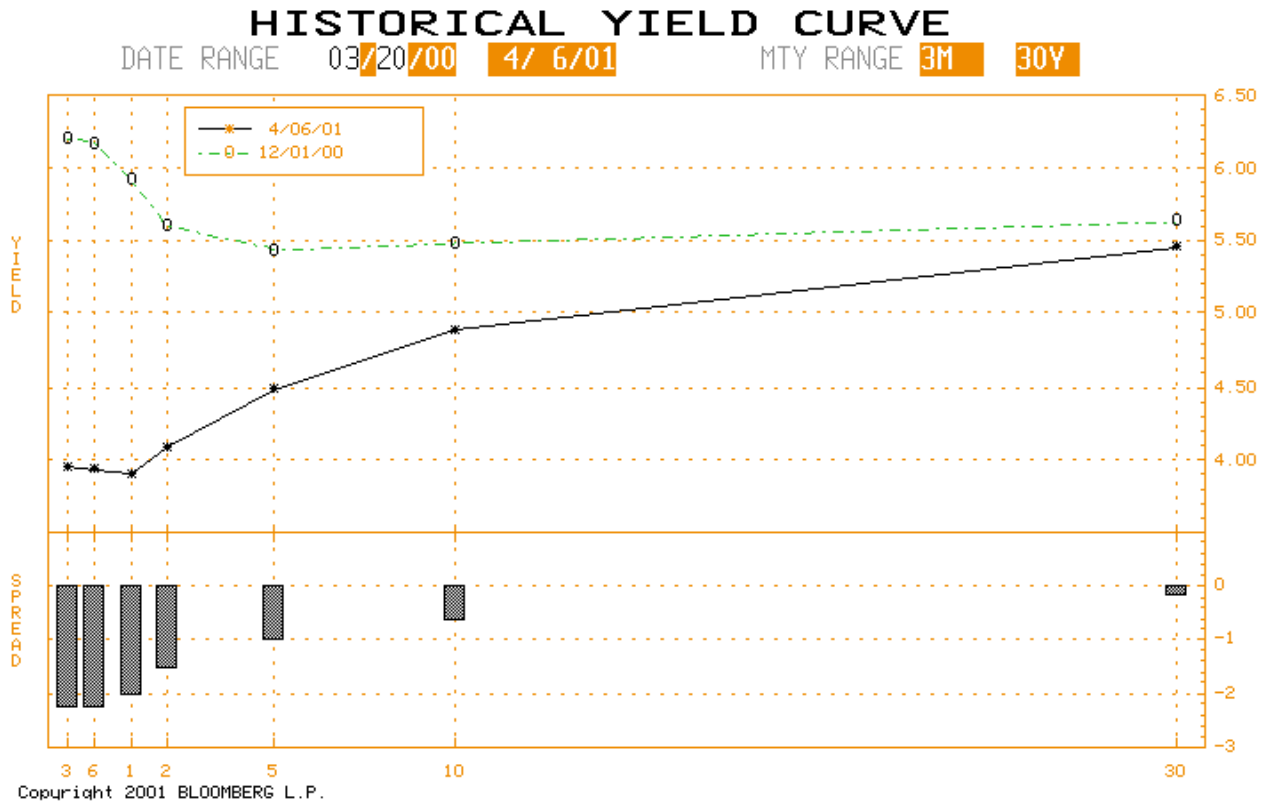
“In these circumstances, when the economic situation could be evolving rapidly, the Federal Reserve will need to monitor developments closely.” This points to further Fed easing and the yield curve taking out the last little bit of inversion. Are we on our way to a 3.75-4.00 Fed Funds rate? Could be? How much more?

Yield Curve changes from 12/01/00 to 03/20/01



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Yield Curve Change Since Last FOMC Move



Where is Federal Fund's rate going? If we are going to have a normally shaped Yield Curve, the Fed is "behind the curve." Sure looks like 3.75%...**3.75% could be a bottom for rates, but the issue for the market is how long is the bottom? We are still in uncharted waters---along with the FOMC despite their public rhetoric.**