Munk Advisory Services

ECOMENTARY™

MAS012904B

Stepping Stones to Patience: FOMC Minutes 12 09 03:

The minutes of the December 9th FOMC meeting provides another data point offering insight into the evolution of recent FOMC statements. Markets have attached considerable significance to the "for a considerable period" mantra since late fall last year. To some, it was the ultimate 'put,' and made the carry trade in all of its various forms the ***trade du jour*** for many months. The "roll down" was extremely attractive, particularly when financed by 1% money. In addition, credit spreads declined sharply in the U.S. and overseas. Similarly, the equity markets, aroused by the strong growth in earnings, widening profit margins and an abnormally cheap cost of capital that stimulated business investment, have put on a spell binding rally that began prior to the last Fed cut (June). In short, many markets were responsive to the Fed's signal that it would be accommodative for a considerable period. Equities in the U.S. continued to rally with some vehemence throughout December and January with the greatest performances being made by the most volatile stocks. In short, cheap money enhanced by the "considerable period" mantra was a tranquilizer to market fear. With a small substitution of phrase, replacing "for a considerable period" with the criterion, "patience," the Fed put some uncertainty around its "put." It might not have chilled the rally completely, but it certainly is working to cool it. Of course, Central Banks don't target assets, so they say. We have heard that line from the Chairman frequently, but the apparent 'suddenness' of the shift, with no Fedspeak to prepare the market for a warning that nothing is forever, has become the dog that does not bark. A curious use of uncertainty as a monetary policy tool!

A close reading of the December 9th Minutes shows, however, that the FOMC has felt a growing discomfort with the terminology that suggests 'time' rather than 'substantive' economic developments as a monetary policy metric. Yet, a Central Bank that desires to communicate efficiently with its audience needs to give clear signals as to how it thinks and what it might take to make a change in policy. "Time on my Hands" is sentimental, but not a metric. Patience in many things is a virtue, but it is also not a metric. Transparency has not yet been achieved, and the use of uncertainty as a way of warning a market that policy changes are in the air, is a way of dampening spirits.

The December minutes reminded the markets that all the usual suspects including jobs, faster wage growth, tighter markets for goods and services would be reviewed in light of any movement in prices. In other words, let the data do the talking. The Committee often frames its thinking in terms of "slack," which is a less than precise way to grapple with the output gap. The Committee, during its "considerable period" phase led markets to feel it would not rush to judgment. Consequently, markets interpreted the repeated stress on the phrase as an invitation to feel confident in lowering long-term yields. Moving to a description of how it will view the economy's datastream ("patiently,") leaves considerable ambiguity and much latitude for the Fed without pinning the Committee to a specific timetable. Yet it is a change, and somehow markets were not prepared for the change. On review, most analysts will not be convinced that the Fed has improved its transparency with this change, albeit it has given some sort of warning signal. We suspect that the next steps will be for the Committee to realize that the market is left with the feeling "less is more, but more what?"

In a key paragraph of the December 9th Minutes, the FOMC refers to its meeting of October 28th during which the Committee expressed its worry. "…they viewed the probability, though minor, of an unwelcome fall in inflation as exceeding that of a rise in inflation from its already low level." As a result, "The Committee judged that, on balance, the risk of inflation becoming undesirably low remained the predominant concern for the foreseeable future." That was how matters stood in October. In the intervening period, the Fed's internal forecast indicated that substantial slack would be reduced due to accommodative financial conditions and strong productivity growth. When the Committee came to discuss the current conditions, a noticeable pickup in economic conditions had occurred. The FOMC explicitly acknowledged a return of business confidence and concomitant outlays that paired with better consumer attitudes to produce conditions closer to a self-sustaining growth path.