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MAS 020205

FOMC meets and tells the market to 'practice your golf game'

This analyst cannot remember the FOMC leaving its "Statement" unchanged on a back-to-back basis, but except for the expected 25 basis point rise, and the deletion of the word "earlier" to describe the rise in energy prices, the statement today (February 2, 2005) matched the Statement of December 14, 2004.

> The Federal Open Market Committee decided today to raise its target for the federal funds rate by 25 basis points to 2-1/2 percent.
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> The Committee believes that, even after this action, the stance of monetary policy remains accommodative and, coupled with robust underlying growth in productivity, is providing ongoing support to economic activity. Output appears to be growing at a moderate pace despite the rise in energy prices, and labor market conditions continue to improve gradually. Inflation and longer-term inflation expectations remain well contained.
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> The Committee perceives the upside and downside risks to the attainment of both sustainable growth and price stability for the next few quarters to be roughly equal. With underlying inflation expected to be relatively low, the Committee believes that policy accommodation can be removed at a pace that is likely to be measured. Nonetheless, the Committee will respond to changes in economic prospects as needed to fulfill its obligation to maintain price stability.

Markets will be left to ponder what FOMC members talked about during the two-day meeting. Undoubtedly, FOMC members took a "balanced" approach on economic data since the last meeting. Inflation was surely expected to be low and expectations "well-contained." With "robust underlying productivity," improving labor market conditions, despite (and maybe because of) higher energy prices, the FOMC thinks it can continue the removal of its monetary accommodation "at a pace that is likely to be measured." In our view, this means, as long as the trajectory of data points on key variable continue to lie along a path that is comfortable to the Fed, it will not change to a more rapid rise in the Federal Funds rate. For bond traders that have benefited from the "carry trade," while the margins have narrowed, there is still sufficient "carry" to continue on the same course. Similarly, for asset holders who have indulged their appetites for housing, autos, et.al. there is only minor pressure to restrain their appetites. In some ways, monetarist critics have also been indulged because the Fed cannot be criticized for "over steering." In a policy world fraught with ideological differentiation (e.g. tax and expenditure policy), the Fed's "neutralizing" course takes out one more uncertainty for investors, and it may even set a rather blasé backdrop for the State of the Union that will occur this evening.

There is an old adage of traders that aptly characterizes the Fed's move today. "When the market is doing nothing, you should also 'do nothing.' In other words, go practice your golf game. That might be a bit difficult give the recent wintry weather, but the Fed has thrown the market a bone in that it has nudged the Federal Funds rate upward, in measured fashion, indicating that the risks to the carry trade continue to increase in a measured fashion. Sooner or later, one of two events will occur, calling golfers back to the office: (1) either the well contained expectations of inflation begin to break out anticipating significantly greater inflation than is now indicated, or (2) the economy begins to turn from a moderate growth pace to a decidedly lower growth rate with consequential deterioration in the job market. Were either scenario to develop the Fed would have to either accelerate its return to interest rate "normality" at a much more rapid pace or it would have to heed the warnings of some of the "doves" in the Fed system who worry that deflation could begin to emerge once again.

It has been hard for either side to the "debate" to gain much traction other repeating "warnings" of what might come without sufficient evidence to make their respective case credible. Time to work on your swing!

ECOMENTARY? is published for clients of **Munk Advisory Services, LLC**
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