Munk Advisory Services

ECOMENTARY™

MAS032107

Fed leaves rate unchanged but recalibrates upside and downside risks

The somewhat erratic economic data stream over the past six weeks has given the FOMC reasons to "pause" both as to rates but more importantly as to how it sees the risks to the economy going forward. While leaving the Funds rate unchanged, the FOMC is now publicly recognizing that housing, inflation and resource utilization trends are causing it to re-evaluate its own probabilities for the economy and for the monetary policy that is appropriate to possibly different types of outcomes. Some questions are going to arise from analysts as to whether the inflation "bias" has been left intact or weakened.

A cursory comparison of the statements of January 31 and March 21 shows the following, significant alterations. In January, the FOMC said, **"Recent indicators have suggested somewhat firmer economic growth, and some tentative signs of stabilization have appeared in the housing market. Overall, the economy seems likely to expand at a moderate pace over coming quarters."**

Today, instead of "somewhat firmer," the FOMC says **"recent indicators have been mixed,"** and there is now an explicit recognition that **"adjustment in the housing sector is ongoing"** as compared to the earlier, January optimism of stabilization." Thus, the Committee buys time to look again at the data, but still stays with its forecast expansion "at a moderate pace over coming quarters." The tone of the statement, however, provides an "out," if the current housing deterioration begins to emerge as a significant economic problem to the downside. That said, however, the focus is on inflation.

The inflation situation has forced the FOMC to acknowledge that inflation is not unwinding at the speed that it had hoped earlier in the year. **"Recent readings on core inflation have been somewhat elevated,'** (3/21/07) as opposed to **"…inflation pressures seem likely to moderate over time."** (1/31/2007). The **"high degree of resource utilization"** which is code for tight labor and commodity markets and higher rates of capacity utilization provide a continuing backdrop for concerns about inflation.

Upside risks: In January, the FOMC addressed its bias by stating that any additional firming to address the inflation risk would depend upon incoming information. In January, while there was a slight bias to the upside, one could argue that the Fed was still focused on a two-tailed outcome. Today's statement, tightens up the inflation bias by stating that **"the predominant policy concern remains the risk that inflation will fail to moderate as expected."**

Downside risks: While stating that inflation is the predominant policy concern, the "out" is maintained by stating **"Future policy adjustments will depend on the evolution of the outlook for both inflation and economic growth, as implied by incoming information."**

In summary, today the Committee's bias against inflation was repeated although palpably weakened by acknowledging that mixed indicators could signal a very different outcome. There is no appeal to the bromide that "inflationary expectations are well contained," a deletion first noted in January. Traders who have bet on a loosening of the Funds rate in the near future are thus warned that the upside tightening is very much an option for the FOMC and growth concerns could be put in second place, at least for now, but can still find solace that economic events might intervene. Even if housing has now become a concern, the first line of defense is guarding against inflation. Still, there is an implicit hedge in the pairing of the predominant policy concern to inflation and the evolution of economic growth. This Fed has begun to hedge, but is a hedging Fed going to get its signal misunderstood by the market? We shall see. Fine tuning has a downside as well as an upside meaning for market players.

ECOMENTARY™ is published for clients of **Munk Advisory Services**, **LLC**
P.O. Box 749, Horsham, PA 19044

Website www.ecomentary.com. Contact: munkb@ecomentary.com