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MAS042104

What's Changed Since March 16th?

The Federal Open Market Committee decided today to keep its target for the federal funds rate at 1 percent.

The Committee continues to believe that an accommodative stance of monetary policy, coupled with robust underlying growth in productivity, is providing important ongoing support to economic activity. The evidence accumulated over the intermeeting period indicates that output is continuing to expand at a solid pace. ***Although job losses have slowed, new hiring has lagged. Increases in core consumer prices are muted and expected to remain low***.

The Committee perceives the upside and downside risks to the attainment of sustainable growth for the next few quarters are roughly equal. ***The probability of an unwelcome fall in inflation has diminished in recent months and now appears almost equal to that of a rise in inflation. With inflation quite low and resource use slack, the Committee believes that it can be patient in removing its policy accommodation***. (March 16, 2004 FOMC Statement)

1. Bond Market 'got it' before Equity Market, but the Currency Market was even faster

GRAB Govt HP

BGN/NY/CLOSE/MID/YTW Page 1 / 2

US TREASURY N/B T 4 02/15/14 96-06 / 96-07 (4.48 /48) BGN @ 8:01

Source BGN HI 102-20 ON 3/16/04

Range 2/13/04 to 4/21/04 Period D Daily AVE 100.03

Market M Mid/Last LOW 96-06+ ON 4/21/04

	DATE	PRICE	YIELD		DATE	PRICE	YIELD		DATE	PRICE	YIELD
F				F	4/ 2	98-26+	4.145	F	3/12	101-26	3.779
T				T	4/ 1	100-31	3.880	T	3/11	102-15	3.700
W	4/21	L96-06+	4.482	W	3/31	101-10+	3.837	W	3/10	102-07	3.730
T	4/20	96-12	4.459	T	3/30	100-27	3.896	T	3/ 9	102-09	3.723
M	4/19	96-30	4.387	M	3/29	100-28+	3.890	M	3/ 8	101-28+	3.770
F	4/16	97-09+	4.340	F	3/26	101-12	3.831	F	3/ 5	101-07	3.851
T	4/15	96-26	4.402	T	3/25	102-04+	3.739	T	3/ 4	99-27+	4.017
W	4/14	97-03	4.366	W	3/24	102-12+	3.709	W	3/ 3	99-18+	4.052
T	4/13	97-06	4.354	T	3/23	102-17	3.692	T	3/ 2	99-20+	4.044
M	4/12	98-05	4.230	M	3/22	102-11	3.714	M	3/ 1	100-06+	3.975
F	4/ 9	98-14+	4.193	F	3/19	101-27+	3.773	F	2/27	100-07	3.973
T	4/ 8	98-14+	4.193	T	3/18	102-00	3.756	T	2/26	99-22+	4.036
W	4/ 7	98-23	4.159	W	3/17	102-11+	3.713	W	2/25	99-29+	4.009
T	4/ 6	98-25+	4.149	T	3/16	H102-20	3.681	T	2/24	99-25+	4.025
M	4/ 5	98-10+	4.208	M	3/15	101-30	3.764	M	2/23	99-22	4.038

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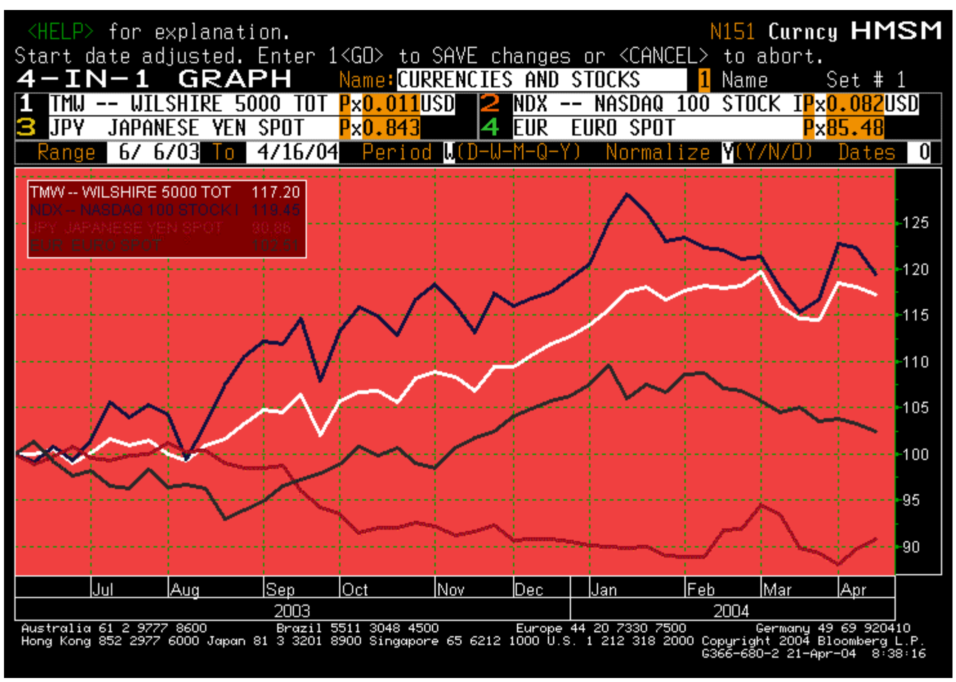
The yield on the 10 year hit 4.402 last week and actually fell back to 4.34 and 4.387 last Friday and this Monday. The rise in yield to 4.482 yesterday was modest ---or one could read this as the Bond Market's very close attention to prices and advanced retail sales earlier in the month had alerted it to an impending change in Fed policies. As one analyst put it to me. 'The Bond Market pays much closer attention to fundamentals because it makes a living picking up nickels in front of a steamroller."

The Currency Market traders began to adjust their sights much earlier, following the adage that you buy the Strong and Sell the Weak Economy. Japan is the exception only because the MOF is willing to spend huge amounts of dollars to insure that a rise in the Yen doesn't topple an already impressive recovery.



Reading from the bottom of the graph above (which plots the Euro and Yen against the Nasdaq and TMW (all in relative terms), it seems that the Currency Markets saw the evident strength in the U.S. economy and 'bought dollars' before the decline in the equity indices. The peak in the Euro came in early January, slightly before the difficulties in the U.S. equity markets became increasingly evident. (January 9th vs January 16th). In fact, the Bond Market didn't reach its low's (on the 10 year) until March 16th until **after** the FOMC statement cited above. It was as if the Bond Market listened very carefully to the "considerable period" and "patience" sentiments expressed at the preceding FOMC meetings. The commitment to be "patient" in 'dis-accomodation' combined with the lure of the Carry was overwhelming to the 'nickel-pickers.' Apparently, the currency traders looked through mists and just bought the dollar and sold the weak European economies. Sooner or later, strength would tell.

2. **What will Dr. G. tell the JEC today?** Having dropped his lead foot, surely Greenspan will have to explain to the markets via his testimony or his Q/A that the conditions specified in the March 16th dictum have now changed. While one data point on the payroll employment series doesn't make a full labor market recovery, we note that Greenspan has always believed that the payroll data are more accurate than the household survey. Second, his off the cuff remarks about deflation---no longer a threat---robs the March 16th statement of one of its principal pivots. Finally, while the recent inflation data are still very modest by historical standards, the change in direction has to have alerted Greenspan to the possibility that the output gap may be closing 'faster,' than some of the other members of the FOMC had thought. We have yet to hear from Bernanke who led the charge on the deflation debate, and it does seem as if his earlier implicit forecasts that the output gap was large and not likely to close quickly, may have been too optimistic. When he next speaks, we would expect him to get in line. The issue now is one of timing the first increase and then outlining to markets what the path of 'dis-accomodation' will be.

3. **Equity Markets:** The fundamental tension point, in our view, has been that equity markets had already discounted by QIV last year, the huge earnings recovery that would take place in QI and QII 2004. In the battle between earnings growth rates and the discount factor, equity markets are now adjusting to the reality that 'nothing is forever,' even abnormally low interest rates. Earnings reports are likely to be highlighted even yet by some very big upside surprises, but the end of the third act is now already in view. In our view, equity markets will struggle for the balance of this year against rising rates, troubled domestic fiscal policy issues and a geopolitical setting that is anything but favorable.