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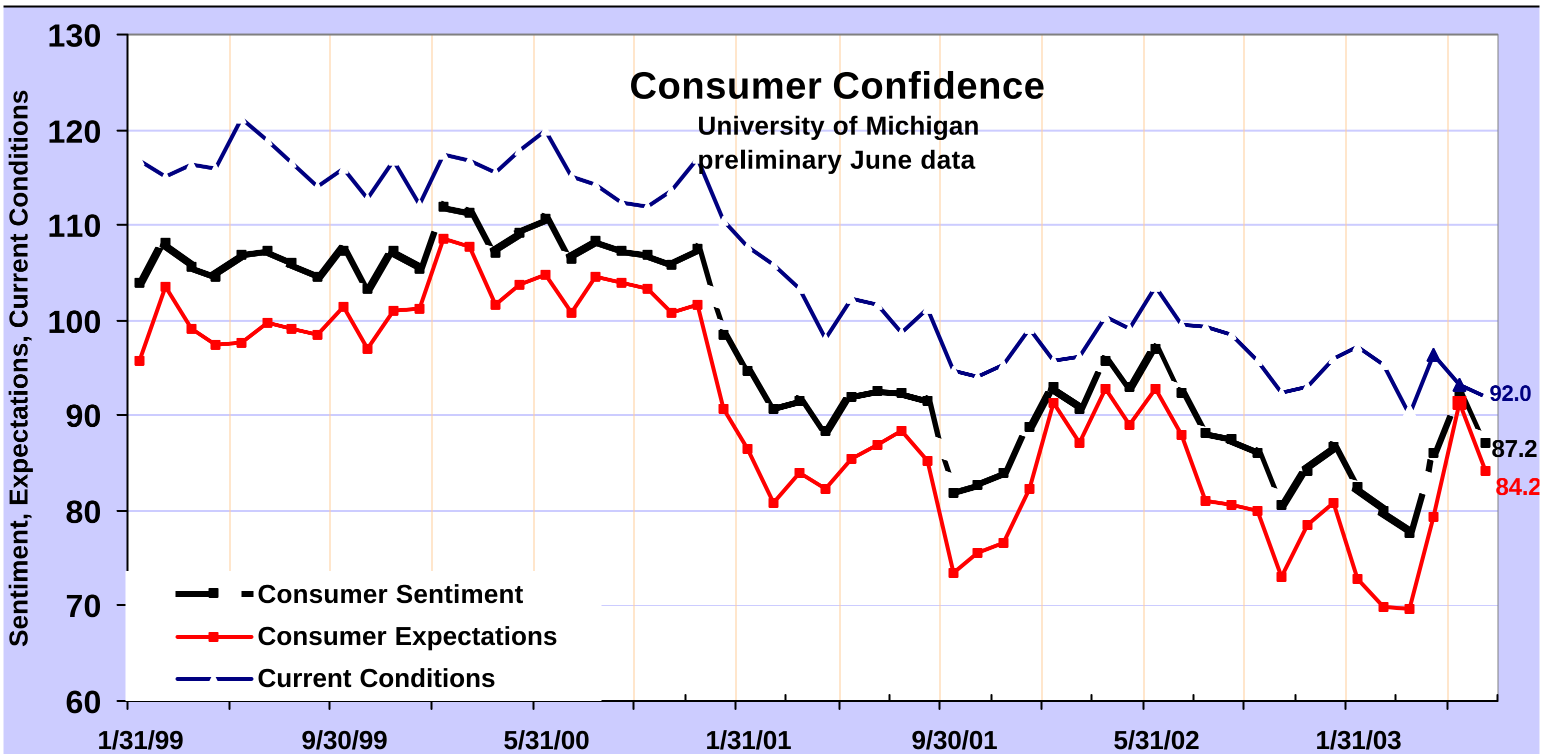
Consumer Confidence Disappoints: a Full Monty for the FOMC?

The professional economist caveat about consumer confidence surveys is that they really don't predict well and often do not contain information additional to that found through the more reliable predictors such as real disposable income and employment. Normally, the FOMC would take a drop such as that shown in the University of Michigan preliminary numbers with some dispassion. Their recent and increasingly frequent public worry about getting out in front of any deflation threat may give this report more weight, however, since it will heighten FOMC sensitivities over the consumer as the last redoubt of their recovery strategy. If she fails,



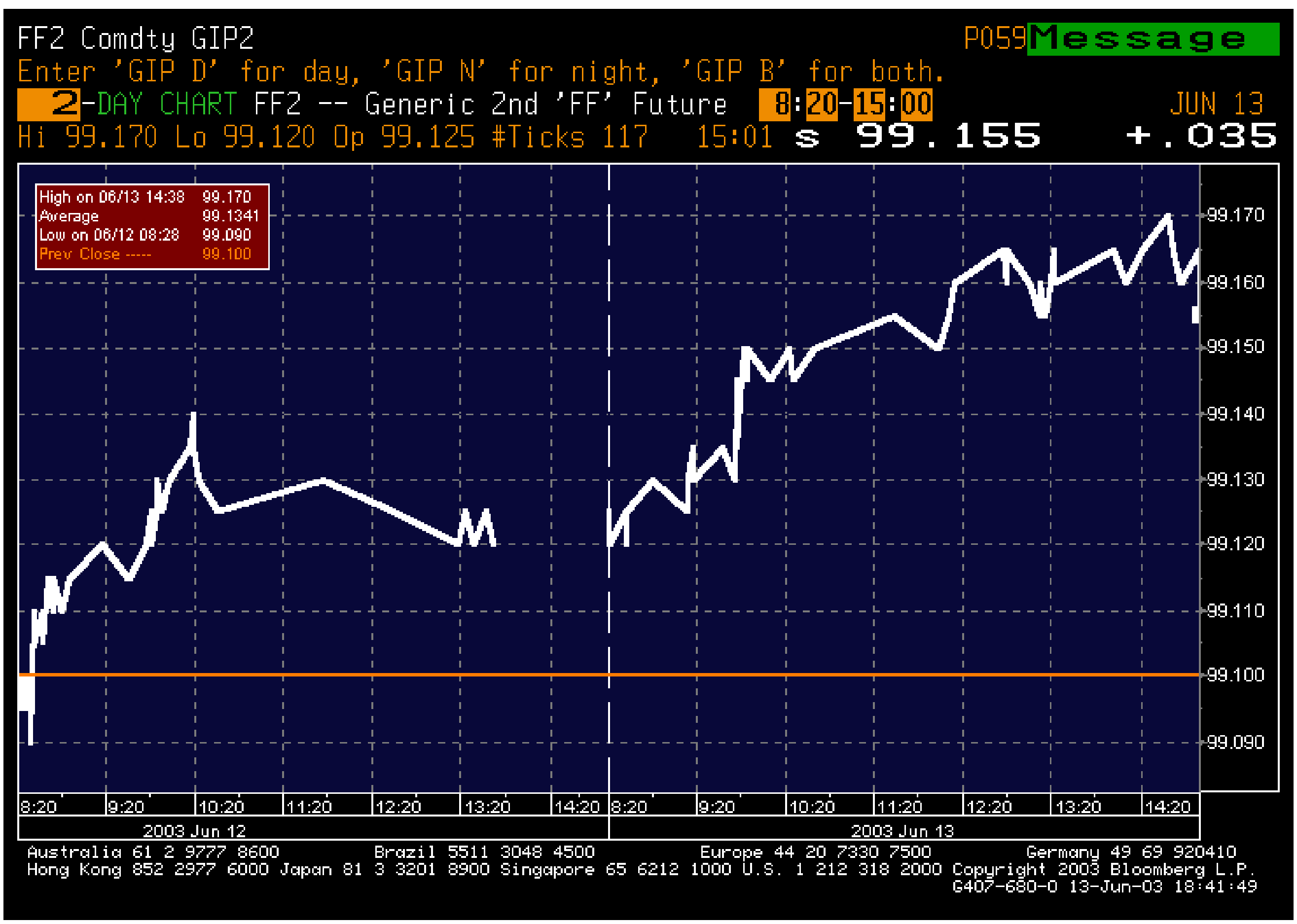
'Katy, bar the door!'

The "disappointment" in today's numbers was pre-figured by the earlier ABC Money Poll suggesting the consumer was more concerned about the future now than last month. Auto sales data have not been zesty lately and the Fed's focus will now shift to the housing data that show up on the 17th (Starts and Permits) and 25th (Home Sales). Both data sets will be available to the FOMC before it renders a decision on June 25th.

The financial market already counts a 100% probability for a 25 basis point cut, and the odds of a 50 point cut have increased sharply in the past two days. Say what you will about the predictable consequences of the Michigan survey data, the market is now hinting that the FOMC is going to be required to do a Full Monty and drop the target rate a full 50 basis points. To do less may suggest weak resolve in spite of recent FEDTALK. The interesting game over the next week and a half will be to conjure up the language to be used in the FOMC statement that accompanies their decision. Last month, the bias statement was restructured to distinguish between growth and price level criteria. This month, the FOMC gets a chance to educate the market more explicitly as to its thinking on that dichotomy. Some market tutoring is clearly in order.

FEDTALK this week evinced further concerns over deflation by Board Member Don Kohn at a Fed Conference in Boston and Philadelphia Fed President, Anthony Santomero at a speech to the Money Marketeers in New York. Both focused on inflation targeting and market expectations. We may not get an explicit commitment to inflation targeting and we might not get explicit statements on 'unconventional measures' such as buying the long end of the curve, but financial markets will not view silence on these issues by the FOMC as golden. The heat is on for further clarity by the Fed on how it sees the recovery's progress, what it is willing to do and when will it be willing to do it!

The odds for a 50 basis point cut will distinctly improve if Jane and Joe Six Pack decide to back away from the auto lots, real estate offices, WalMart and Home Depot and/or the FOMC comes to believe that they must ratify the sharp downward movement in the yield curve, particularly at the long end. Credit market raised the odds of a 50 point cut with moves in the Fed Futures market over the past two days as indicated in the second



month Fed Funds futures contract.

The survey data also raise the question of how the consumer is likely to feel with some extra cash from the tax cut. The forward measures suggest not to bet the ranch.

The game plan at the Fed has been to strongly provoke an intertemporal shift of consumption from the "back" to the "front" via strong incentives of lower interest rates and induced home equity cash outs from attractive mortgage rates. The FOMC will find it hard to back away from that path and hesitance in any form by the Fed will cause the Bond Vigilante's to question the sustainability of the yield crash that Fed policy is inducing. After issuing a White Paper on the Lessons from Japan, it will be difficult for the Fed to do even slightly less than the Market might hope for. Even staying in the same place will be seen as a reversal

"Half a League, Half a League, Half a League Onward[1]" It will be very difficult for the FOMC to do less than the max.

[1] Readers should not infer from the invocation of Tennyson's memorable lines that the outcome of the Fed's assault on the yield curve and the Charge of the Light Brigade will have parallel results!