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The Maestro's Malapropisms: consistency needed this time

I. Greenspan may get an A for his forecasting prowess, but he will flunk as a central bank market timer

II. The Market wants certitude (Henry the Fifth) not nimble soliloquies (Hamlet)

III. Credibility is the only weapon and the Fed is likely to lose some its bounty

IV. What the Message needs to say!

If you are handicapping the outcome tomorrow, the bottom line is that the FOMC will turn out to be time inconsistent. Surprised? You shouldn't be, but the Bond market will not like it.

In his July 15,2003 statement to the Senate Banking Committee, the Chairman said

> **When in late April I last reviewed the economic outlook before this Committee, full-scale military operations in Iraq had concluded, and there were signs that some of the impediments to brisker growth in economic activity in the months leading up to the conflict were beginning to lift.**

And he followed those opening remarks with a kind of forecast.

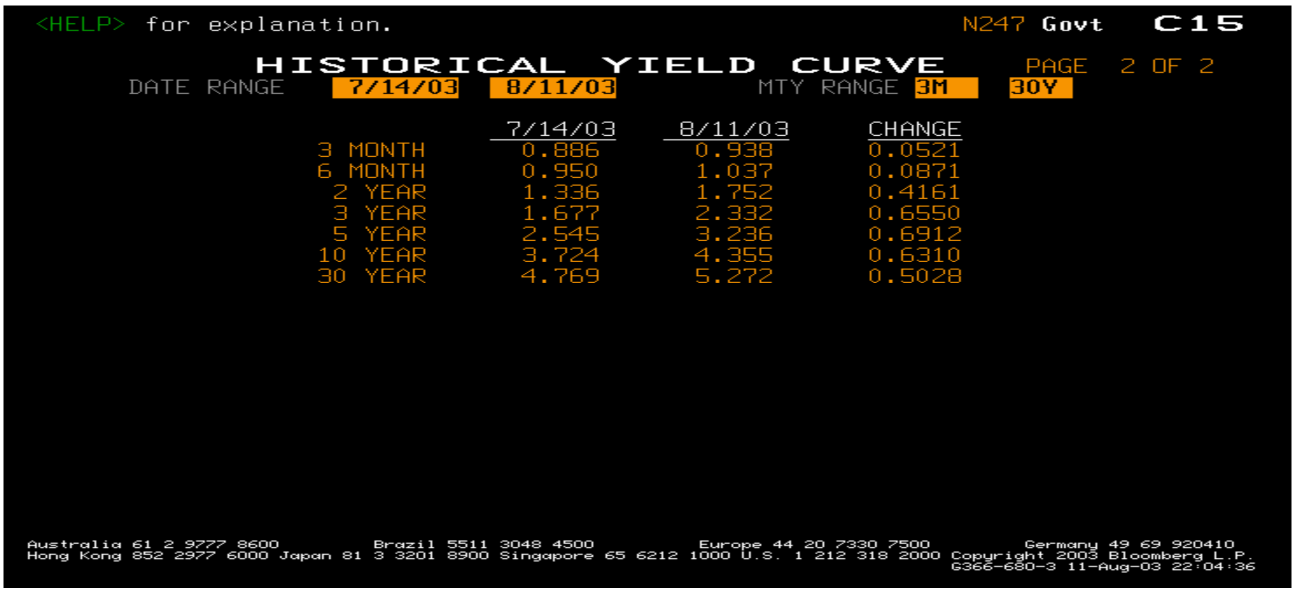
> **Stock prices had risen, risk spreads on corporate bonds had narrowed, oil prices had dropped sharply, and measures of consumer sentiment appeared to be on the mend. But, as I noted in April, hard data indicating that these favorable developments were quickening the pace of spending and production were not yet in evidence, and it was likely that the extent of the underlying vigor of the economy would become apparent only gradually.**

How good was the forecast? In some respects, excellent, if the recent run of macro data points are considered. GDP came in at 2.4% for QII, but positive signals can be seen in retail sales, housing, durable goods, personal consumption, non-manufacturing activity, vehicle sales, business investment spending and to some extent a recent downward trend in initial job claims. Still lacking are other good signs in the labor market (hours, job creation and a sharp fall in the unemployment rate). Consumer confidence signals are mixed but not unduly worrisome. The deflation news is no worse, depending upon the index used, but the 'margin of safety,' that some of Greenspan's colleagues on the FOMC desire still has not been achieved.

What about financial markets? The Dow is slightly ahead of its 7/14 close. The S&P has slipped, but the NASDAQ has fallen more sharply from its high the day prior to his testimony (7/15/03) from 1754.82 to a close at 1661.51 on 8/11/03 (5.3%) Perhaps more importantly, interest rates except for the tethered Federal Funds rate, have exploded upward. The generic 10-year bond hit its low yield of 3.114 on 6/13/03 but rose to 3.726 by the close before Greenspan's Senate testimony. After his testimony, that same generic bond yield lifted to 4.355, a further 63 basis point rise making it 124 basis points since the June 13th low. The Chairman gets good marks for economic forecasting but the bond market will not praise him for what he has done with bond market expectations.

If the purpose and intent of the FOMC statement on June 25 was to restrain the observable rise in interest rates, it did not succeed. And, if that was not the purpose of the statement, then the FOMC has already entered into the zone of time inconsistency. After reassuring the bond market in May that it wished to avoid an "unwelcome substantial fall in inflation" (code for deflation), the June meeting unsteadied the market by its tepid 25 basis point cut while maintaining the dual bias statement that focused on the risks of an unwelcome substantial fall in inflation. In effect, wittingly or not, the FOMC confirmed the Bond Vigilantes' suspicion that the bond party was over. It is hard to believe that the Chairman is willing to reverse their views by an unsuspected cut in the rate. That said, the bond market is right! The party has come to an end.

Of course, the consequence of the interest rate spike for the 10-year has been to create strong upward



<HELP> for explanation. N247 Govt C15

HISTORICAL YIELD CURVE PAGE 2 OF 2

DATE RANGE 7/14/03 8/11/03 MTY RANGE 3M 30Y

	7/14/03	8/11/03	CHANGE
3 MONTH	0.886	0.938	0.0521
6 MONTH	0.950	1.037	0.0871
2 YEAR	1.336	1.752	0.4161
3 YEAR	1.677	2.332	0.6550
5 YEAR	2.545	3.236	0.6912
10 YEAR	3.724	4.355	0.6310
30 YEAR	4.769	5.272	0.5028

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pressure on mortgage rates and a sharp drop in "refi." To date, rising mortgage rates have not yet cratered the housing market, but surely we have seen this refinance cycle's peak. Furthermore, if the 'driver' for this bust was the mortgage trade's need to sell the 10-year to protect itself from rising duration consequent on slower mortgage payoffs, there is no assurance that more pressure from that trade is a thing of the past. The spike can get worse.

Now comes the stretch between consumer spending, spending on housing and the needed lift in business investment to replace the likely fade of housing expenditures. While there are some indications that business spending has picked up, the FOMC will surely have to consider whether the market got the "signal" that the Committee wished to send last June 26. The behavior of rates does suggest that the market drew quite a different inference from the Committee's directive. The Bond market seems to be ill at ease with Greenspan's apparent ambiguity. It wants Henry the Fifth certitude, not the Hamlet-like soliloquies of a Central Banker using calculated ambiguities. The market has been unable to decipher Greenspan's code. Does he think deflation is a real risk, or is it merely a sop to an intense campaign by some FOMC Members to point out the risks of a monetary policy and monetary targets that do not explicitly address deflation?

We have long suspected that there is a true rift in this FOMC. Part of it may be due to a difference in forecasts for the economy. More likely, it is not the forecast, but differences in views on how monetary policy changes should be communicated to the market. The inflation targeters---like Dr. Ben Bernanke---want to bring out into the open how the two targets (growth and inflation-deflation) should bear on the risk assessment and indeed the exercise of monetary policy by the Fed. That would force much more explicit statements. That brings to the fore the issue of transparency. How does this Fed really view transparency and how does it feel about tying its future to a more restrictive set of options on future monetary policy actions?

Greenspan has always believed in sailing close to the wind. Discretion is his preferred métier. He has shown repeatedly that he does not wish to be tied down by a formulated approach to monetary policy. The discretion that Greenspan wishes to keep alive, however, works against his own views on Central Bank credibility. Transparency of monetary policy actions is arguably the only way in which Central Bank credibility can be maintained.

The Fed has been promising the market that it will take the risk on the inflation side until it is completely obvious that the economy has reached self-sustaining growth. The market clearly doubts that resolve, unless one want to believe that the bond market has become wildly optimistic over the economy's most likely future course. If it believed that the next Boom was just around the corner, one might think that inflationary expectations would begin to show up (say in the TIPS spread). They have not done so, and we must conclude the bond market is suspicious of the Fed itself. Greenspan has led the market into the thicket. To restore market confidence, he would have to delineate quite clearly the path out of the wilderness. We view that as a 'likely impossibility,' as Aristotle once said.

That brings us full tilt to the most likely outcome at tomorrow's FOMC meeting. The "worst" outcome might be an actual rise in the Fed Funds rate, but it would be very hard to justify. The next option might be if the FOMC changed the bias because it claimed that the neutral zone had been reached on price level behavior. (a return to a 'neutral' bias on both targets). In our view, the last option---- no change in the two risk assessments and no change in the Fed Funds rate---is the most probable, but there is a hitch. To make that assessment credible, the FOMC has to drive its horses through a narrow canyon. It must point to the need for continuation of the "accommodative stance of monetary policy," and it must do so in the context of recognizing that some of the data points are actually pointing to a stronger recovery. This implies that it must be willing to tell the market in some fashion it is prepared to overshoot the target and risk some inflation! Wouldn't that give Dr. Bernanke a surprise? An explicit intent to overshoot?

Is it likely that an esteemed central banker is prepared to announce an overshoot? We find that highly unlikely. That would be tantamount to admitting that the prior statements have been much too tepid in their attack on the deflationary threat and it would suggest that the Fed is prepared to do something that is less than "optimal" in order to avoid time inconsistency. The bond market doesn't believe that and neither do we.

The Chairman may well turn out to be right on the timing of recovery, but the Fed will need a long time to rebuild the trust of the bond market. At the end of the day, Mr. Chairman, they will be saying, "First time, Shame on You. Second time, Shame on me!" Or, should we say, "Show me the Money?"