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Downunder Daily

Don't Care What You Say

It's rare that markets are as dismissive of Fed rhetoric as they appear to be now. The tone of recent Fed commentary has been cautious, but even-handed, with several members still concerned about inflation. Certainly, there's little evidence that a rate cut at the upcoming FOMC meeting is a done deal, let alone that the Fed is preparing for a sequence of cuts beyond that. Yet that is what short-end markets are pricing with increasing confidence (Exhibit 1).

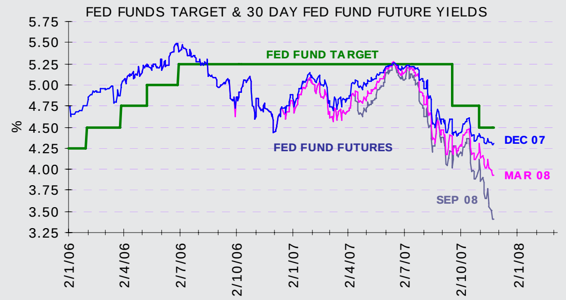
A few thoughts from me:

First, short-end futures markets have an imperfect record as Fed policy forecasters. (That's not to say that the market is better or worse than anyone else – I haven't done the comparison.) But it's noteworthy that, on a six-month horizon, the market gets easing cycles more wrong than tightening cycle. Markets get them wrong by under-estimating the extent of the rate cuts. Exhibit 2 shows the gap between the six-month-ahead Fed fund future and the Fed fund target that eventuated. It's not uncommon for the Fed to cut by 100-200 basis points more than is in the futures price six months' prior. In contrast, the typical error in a tightening phase is significantly smaller.

Second, the rate cuts now priced in, around 100 basis points over the coming 12 months, are consistent with a significant slowdown in growth. They are not, in my view, consistent with recession. Aside from Paul Volcker's famously hard-line response to the 1980 recession, every other recession in the US has led to much sharper falls in short-end rates than is now being priced. In the other recessions over the past 40 years, the *slowest* fall over a 12-month period was a reduction of 300 basis points through calendar 1991 (Exhibit 3). In other words, if the US does fall into recession, it's very likely that (again) the short-end futures will have grossly under-estimated the pace at which the Fed cuts rates.

Exhibit 1

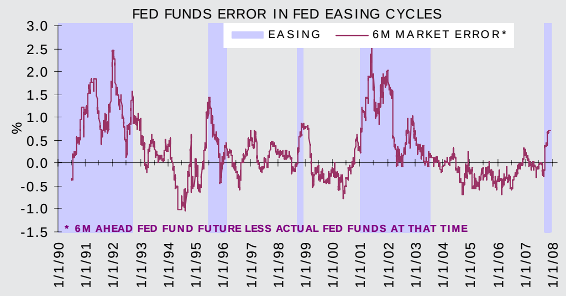
What the Market Thinks the Fed Will Do



Source: Bloomberg; Morgan Stanley Research

Exhibit 2

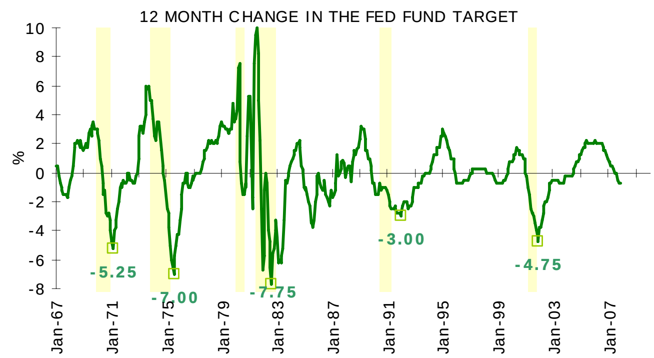
Under-estimating Easing Cycles



Source: Bloomberg; Morgan Stanley Research

Third, the market clearly now assumes that, regardless of Fed officials' comments, if the growth data do turn weak, the Fed will cut. I agree. It has ever been thus, and despite a falling dollar and rising oil price, I'd expect that this time would be no different.

Exhibit 3
The Fed Cuts Sharply in Recessions



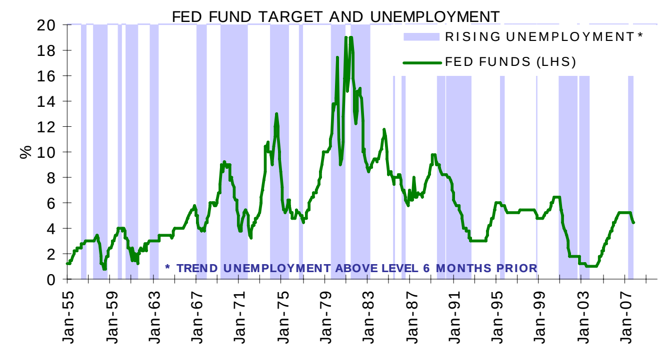
Source: Federal Reserve, NBER, Morgan Stanley Research

Fourth, in that context the market's high conviction that the Fed will ease at the December 11 FOMC meeting is a strong bet that the economic data will turn weak enough soon enough to force the Fed's hand. I'm bearish on the US, but getting data weak enough to force the Fed's hand on that time-scale seems to me to be no certainty. The near-term focus will be on reports from retailers on the post-Thanksgiving sales performance. Beyond that, I continue to think that labour market data remain the single most important indicator. The November payroll report, due December 7, therefore will be critical.

As Exhibit 4 shows, historically the Fed almost always is easing when unemployment rises, and almost never cuts when it's not. This cycle fits the same pattern. (The unemployment indicator in Exhibit 4 is whether or not the trend unemployment rate is rising over a six-month period. In this cycle, that first occurred in June, based on current data.)

Having said that, it's unusual that Fed officials have not tried to bring market expectations back in line with what appears to be the Fed's sense of the risks. Colleague Ted Wieseman notes that if the Fed is going to 'correct' market expectations – or change its stance to fit with the market's – then the best chance is a speech on Wednesday by Fed Vice-chairman Kohn.

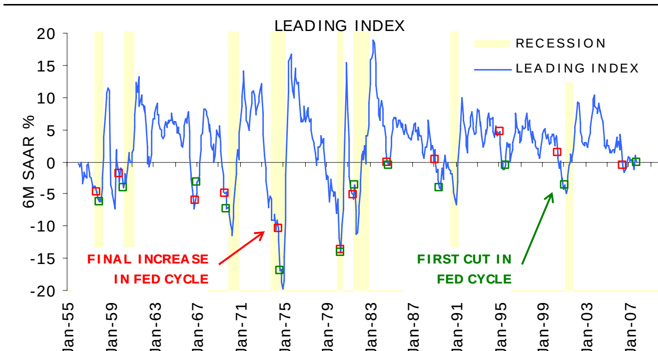
Exhibit 4
Following the Laggard…



Source: Federal Reserve, BLS; Morgan Stanley Research

The final point is an aside: it's ironic that unemployment – one of the most lagged cycle indicators – provides such strong guidance to an ostensibly forward-looking Federal Reserve. In contrast, forward-looking indicators do not. Exhibit 5 shows the Conference Board's leading index, with the last Fed tightening and first rate cut indicated for each cycle. Often the Fed has waited until the leading index is falling or flat before its stops tightening, although to be fair the record is now better than it was (up until the 1990s the Fed was often tightening even as the leading index was contracting). The coincidence of unemployment changes with Fed policy changes does suggest, however, that even the Fed has limited confidence in its own ability to forecast cycle turning points.

Exhibit 5
…Ignoring the Leader



Source: Conference Board, NBER, Federal Reserve; Morgan Stanley

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