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Market Facts

First Comparative Assessment Of August 5th FOMC Meeting

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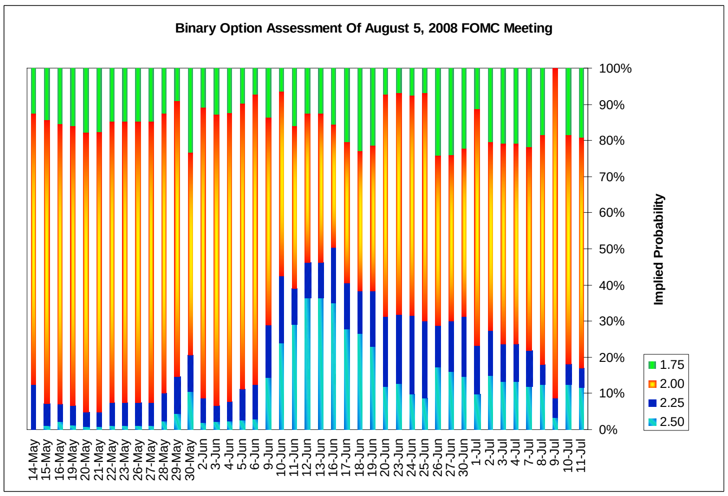
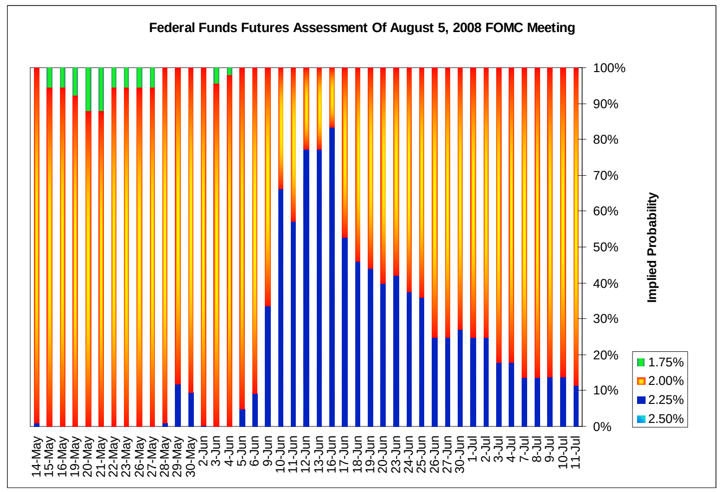
The binary options market (left-hand chart) now is pricing in a 19.0% probability of a 25 bp rate cut, a 5.5% probability of a 25 bp rate hike, an 11.7% probability of a 50 bp rate hike and a 63.8% probability of no action at all.

The federal funds futures market (right-hand chart), which settles to the average effective rate and not the target rate, continues what has been a binary outcome. Here there is an 11.5% probability of a 25 bp rate hike and an 88.5% probability of no action at all.





Conclusion

We concluded in September 2007 the Federal Reserve had damaged its hard-won transparency beyond repair. Then they really got busy; while it is hard to conceive of them topping their January 2008 performance wherein eight different outcomes had a finite probability, they did manage to convince the federal funds derivatives markets in June they were going to get serious about fighting inflation. Please note the rise and fall of the blue columns in the charts above, especially for the futures. The markets took the bait.

Now that the situation has deteriorated with frightening rapidity once again, with IndyMac pushed into receivership, with Fannie Mae and Freddie Mac's ability to remain intact "in their present form," as if that should provide reassurance to anyone given their track record, is in question and with certain macroeconomic indicators such as relative stock-bond valuations and personal savings rates flashing warnings of potential deflationary forces, should anyone care what the Federal Reserve does with the next 25 basis points?

Are they fighting inflation or deflation? Will 25 basis points matter to Fannie Mae, Freddie Mac, or General Motors for that matter? Do they care about the dollar and/or any two commodities of your choosing?

The answers to these multifaceted and conflicting questions are simple: If they are to loosen in response to the mortgage fiasco, they will do it with another set of extraordinary facilities and measures. If they tighten, 25 bp higher on a federal funds rate 65 bp below two-year expected inflation is insufficient.

Restated, the market is correct to place its modal bet on no action at all for the simple reason we can make no convincing arguments for a policy change at this point. Moreover, the realization we cannot assign a deterministic outcome to a change in monetary policy should be absorbed by one and all for future reference: Those who cannot predict the outcome of their actions should be precluded from undertaking them. The two great economic catastrophes of the 20th Century, the Great Depression and the Great Inflation are being joined by the 21st Century's Great Unwind. All are attributable to monetary policy. When is enough enough?

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