

The Fed faces a tough balancing act

The Federal Open Market Committee (FOMC) will meet on June 23rd and 24th. The FOMC is expected to hold rate policy steady and its target range for interest rates unchanged at 0.00-0.25%. The FOMC is also expected to maintain its current target for the purchase of bonds and mortgage debt. How the Fed elects to respond, if at all to the recent rise in US mortgage and long-term bond yields will be key to the market impact of the FOMC meeting. Over the past few weeks' speculation emerged that the Fed may raise interest rates before year end to combat rising risk of inflation. Fed fund futures are forecasting a 40% chance that the Fed will raise interest rates 0.5% before December 2009.

The Fed faces a tough balancing act trying to boost the economy without creating inflation. At the April FOMC meeting the Fed elected to hold its current rate target unchanged at 0.00- 0.25% and to maintain the current level of asset purchases. Earlier in the year the Fed announced that it will purchase a total of \$1.2 trillion of agency mortgage-backed securities and up to 200 billion of agency debt by the end of the year. The Fed also said that it will buy 300 billion treasury securities by the fall. US long-term interest rates have been rising despite the Fed's bond purchase plan. The rate rise partly reflects a sharp increase in the US budget deficit and supply of bonds to service the deficit. The Treasury will auction a record \$104 billion in bonds this week. Long-term interest rates are also rising because the Fed's asset purchase plan has expanded its balance sheet and this could increase the risk of inflation.

The three key questions investors will be looking for the Fed address at the June FOMC meeting are 1) will the FOMC elect to expand its purchase of bonds to try to drive interest rates lower?, 2) will the FOMC announce a set time frame for interest rates to remain at the current low-level? and, 3) what is the current Fed view of the US and global economy?

The Wall Street Journal reports that the Federal Reserve is not concerned about the recent rise in interest rates because the rise in rates is an acknowledgment that the economy is recovering. According to the Wall Street Journal, the Fed is more confident that they have stabilized the economy and that the economy is set for recovery. The main debate at the Fed is whether they should be doing more to boost economy or start pulling back to avoid an outbreak of inflation. A fourth question that investors look for the Fed to soon address is an exit strategy from quantitative ease. The Fed is not expected to announce an exit strategy until the FOMC is confident of US recovery. Based on the current level of US economic activity the Fed is unlikely to announce an exit strategy from quantitative ease at the June policy meeting.

The Fed may announce a plan to increase the purchase of bonds at the June FOMC meeting. The FOMC may also state that interest rates will remain low for a set or extended period. What the FOMC says about the US and global economy will be key to investor sentiment and fading hope of a quick global recovery. In Monday's trade, equity and commodity markets were pressured by report that the World Bank said that the global economic contraction will be deeper than they had originally forecast. If the Fed concurs we could see a more substantial correction in the global equity and commodity markets. The April FOMC statement said that the US economy continued to contract but the pace of contraction appears to be somewhat slower. According to the April FOMC statement economic recovery is likely to remain weak for sometime.

The impact of the June FOMC meeting should be limited as the Fed is widely expected to leave its target rate at 0.00- 0.25%. The Fed is also expected to affirm its commitment to quantitative ease. If the Fed announces an expansion of its bond purchases the USD could fall sharply. If the Fed upgrades its economic outlook the upgrade may boost global equity markets and the USD could weaken pressured by improving risk sentiment. If the FOMC emphasizes the risks to the

economic outlook USD may benefit from safe haven demand. The Fed may want to dampen rate hike speculation by electing to announce a set period the Fed will keep short-term interest rates low. The FOMC communiqué may include a statement that the Fed will keep short term rates low for an extended period. The Fed is not expected to change monetary policy until they are certain a recovery is in place. An extended period of low Fed interest rates would be a mild negative for the USD. Finally, the Fed may also be considering revamping the repo market because of concern that the structure of the repo market may have exacerbated the financial crisis.

By Michael J. Malpede,

Michael J. Malpede is Chief Market Analyst with Easy-Forex and has previously been featured on Bloomberg TV, Bloomberg radio, Reuters, MarketWatch, Wall Street Journal, Chicago Tribune, Chicago Sun Times, Toronto Star and Nikkei press. In analyzing the markets, he draws from 29 years of Foreign Exchange Research as a Foreign Exchange Analyst.

Please note that Forex trading (OTC Trading) involves substantial risk of loss, and may not be suitable for everyone. This report is provided by Easy-Forex™ for informative purposes only. In no way it is a recommendation by Easy-Forex™ for you to engage in any trade. It is your sole responsibility and you will have no claims with regards to this report against Easy-Forex™. If you do not agree to this, you are strongly advised not to use this report. Hence, Easy-Forex™ shall not be held responsible for any outcome of trading decisions, in regards with this report or similar reports.