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TRENDMACRO LIVE!

On Fed Open Market Operations

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The Fed now is doing what a central bank should do: providing sufficient liquidity to keep markets from seizing up in times of stress, and making a public point of emphasizing their willingness to do so. However, the stepped up open market operations over the past couple days, including a three-step \$38 billion injection of temporary reserves today, has no direct implications regarding the potential for an outright rate cut in response to the turmoil. In fact if anything, the Fed's handling of the event suggests it remains disinclined to undertake a policy adjustment at this point.

In an announcement today, the Fed said it is "providing liquidity to facilitate the orderly functioning of financial markets," and that it "will provide reserves as necessary through open market operations to promote trading in the federal funds market at rates close to the Federal Open Market Committee's target rate of 5-1/4 percent." That can be seen as suggesting that the Fed sees current requirements as consistent with that rate. Over the past two days, the Fed has put nearly \$60 billion on offer at the going rate, and has had no difficulty finding takers. In fact, the Fed has accepted less than 30% of the total bids. In earlier crises, the Fed has had to cut its target rate -- or, as in the case after 9/11 terrorist attacks, drop it entirely -- partly in order to generate enough borrowing interest in the funds it sought to supply.

No question, liquidity in the banking system has been at a premium the past two days. Today, fed funds were trading at 6% at the open, prompting the Fed to come in earlier than normal with its first large injection. By early this afternoon, the rate was back down to target. In an apparent effort to lend at least symbolic support to the mortgage market, the Fed said all the collateral it accepted today was mortgage-backed securities. But we again note the important distinction between this episode and other seemingly similar incidents, which were symptomatic of deflationary liquidity crunches. In 1998, for example, gold had fallen some \$50 by late summer from its already deflated level around \$330 late the previous year. In its current range around \$670, gold remains more than 75% above its 10-year moving average. Moreover, after a sharp sell-off in yesterday's flight to liquidity, gold today recovered the bulk of its lost ground, trading around \$672.

Update to strategic view

FED FUNDS: Yesterday's and today's injections of liquidity by the Fed suggest that the existing funds rate target of 5.25% is adequate to meet the market's needs, and that the Fed is therefore not likely to cut rates in response to the present distress. Market expectations to the contrary should begin to unwind quickly.

[\[see Investment Strategy Dashboard\]](#)

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BOTTOM LINE: This perspective should be kept at the forefront in determining the appropriateness of calls for the Fed to cut rates in response to current developments. If the turbulence is strictly due to a repricing of risk, with no origins in monetary stringency -- which is what we see as clearly being the case -- a rate cut would be a considerable error. As of Tuesday, the Fed also appeared to see it that way (see ["The Fed Gets It Right"](#) August 8, 2007). The Fed's more abundant reserve operations, and its statement explaining its objectives, appear today to have contributed to at least a marginal diminution of the market's stress levels. Should that continue and a marked measure of stability be restored over the next several sessions, expectations for aggressive Fed rate-cutting that have been built up in the markets the last few days should just as rapidly unwind, which is what we anticipate. ▶