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Cut or No Cut

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We still think it's an open question, but either way stocks and inflation plays will do well.

The Fed doesn't *want* to cut the funds rate -- it would have already if it wanted to. We don't think the Fed *should* cut the funds rate -- it has already done the right thing, in accordance with Ben Bernanke's own preferences, to ease the present credit market turbulence by cutting the *discount* rate and liberalizing its borrowing terms, and through extensive open market operations (see "A Surgical Strike" August 17, 2007). And we've maintained that the Fed *won't* cut the funds rate -- practically the last people in the market to think so --- believing that incoming macro data between now and the September 18 FOMC meeting won't be bad enough to compel a cut (see "Don't Count Your Doves" August 30, 2007). Nevertheless, we warned several weeks ago that "the market's urgent expectations for rate cuts could potentially exert an irresistible demand effect on Ben Bernanke" (see "2007 and the Ghosts of 1998" August 16, 2007). Now with less than two weeks till the next FOMC, and those rate cut expectations as urgent as ever, we have to admit that our beloved no-cut forecast may be on the way to getting pried out of our cold dead hands.

Update to strategic view

FED FUNDS: We have to concede that a demand effect exerted by market expectations could move the FOMC to cut the funds rate on September 18, though we believe that the Fed doesn't want to and still may not do so.
US STOCKS: Rate cut or no rate cut, stocks are likely to continue to traverse a rocky road toward recovering their losses from the July highs -- a rate cut would be an accelerant.
US RESOURCE STOCKS: A rate cut would intensify already existing inflation impulses, so we continue to favor the most inflation-sensitive stock sectors, energy and basic materials. These sectors are already bounding back aggressively from disproportionate losses in the present stock correction, and a rate cut would be an important accelerant.

[see Investment Strategy Dashboard]

In terms of the fundamentals, we don't see it mattering much if the Fed does, indeed, cut rates on September 18 by, say, a toe-in-the-water with 25 bp. We don't think such a cut is necessary or appropriate to stimulate the economy, which we see as already strong. Today's *Beige Book* would seem to agree -- at least so far, the Fed sees that "Outside of real estate, reports that the turmoil in financial markets had affected economic activity during the survey period were limited." And a cut is not necessary to support stocks, which throughout the current crisis, have tended to go up when rate cut expectations go down, and down when rate-cut expectations go up (see "Stocks Don't Need a Rate Cut" August 31, 2007). Further, since a cut is fully expected, the reaction in markets overall should not be terribly dramatic -- especially since the FOMC is not likely to bind itself to

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further action one way or the other without justification by macro data. There could be some initial and brief disappointment that the cut was not more, or that the FOMC was not more overtly committed to future cuts. And no doubt Bernanke would be compared unfavorably to Alan Greenspan, who according to legend would have preemptively cut rates already if he were still chairman (though in the 1998 crisis, he didn't cut rates until the S&P 500 had fallen almost 20%, and in this crisis it hasn't even fallen by 10% at the very worst of it). But if we are right that the economy -- and stocks -- didn't really need a rate cut anyway, then any disappointment should be brief.

A cut would spare the markets the angst of having their expectations defeated, and so would avoid some additional turbulence -- which is precisely why the Fed may well bow to the demands of expectations. But other than that, in some sense a rate cut would be pure gravy. Stocks will do well without one, and maybe even better with one. But that gravy will not be free. Long term, a rate cut would intensify already existing inflation pressures borne of the Fed having created so much excess dollar liquidity over the last several years. If the Fed cuts the funds rate, those impulses will only be intensified. Already the inflation-sensitive elements of world markets are reacting. The dollar, which should have rallied over the last six weeks of seeming liquidity strain, has instead done nearly nothing, and now stands less than 1% from all-time lows on a trade-weighted basis. Gold, which should have collapsed in a true liquidity crisis, never fell much to begin with over the last six weeks, and now stands near its highest levels since the crisis' onset, and only 6% off its cycle highs of last spring. Oil has behaved similarly, now almost 50% above its lows for the year and less than 4% from all-time highs.

Similarly, since the bottom of the present stock market correction on August 15, the two best-performing S&P 500 sectors have been the two most inflation-sensitive ones -- energy and basic materials (as we predicted: see "Thoughts After a Very Rough Week" July 30, 2007). A rate cut would be an accelerant to these sectors, but even without a cut, they remain our favorites. Not only are they springing back from having been what we predicted would be the "babies thrown out with the bathwater" (again, see "Thoughts After a Very Rough Week") -- but more significant, they occupy the sweet spot where global growth and existing liquidity excesses intersect.

BOTTOM LINE: We have to concede that a demand effect exerted by market expectations could move the FOMC to cut the funds rate on September 18, though we believe that the Fed doesn't want to and still may not do so. Cut or no cut, stocks are likely to continue to traverse a rocky road toward recovering their losses from the July highs -- a rate cut would be an accelerant. A rate cut would intensify already existing inflation impulses, so we continue to favor the most inflation-sensitive stock sectors, energy and basic materials. These sectors are already bounding back aggressively from disproportionate losses in the present stock correction, and a rate cut would be an important accelerant.