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FED SHADOW

Confusion Reigns

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The Fed is trying to help, but its clumsiness is undermining confidence rather than enhancing it.

Update to strategic view

FED FUNDS: Though the Fed cut rates by 25 bp instead of 50 bp, nothing in the FOMC statement or in this morning's announcement of a new global funding facility gives markets any reason to stop bullying the Fed to cut rates even further. The disorganized way in which the Fed coordinated yesterday's and today's actions reveals its confusion and weakness, and will embolden the markets that have the Fed effectively under speculative attack.

[see Investment Strategy Dashboard]

In one sense, it's welcome news that the Fed may finally have hit upon an instrument that will deal directly with the interbank funding issues that have given rise to such angst in the credit markets. The supplemental discount window credit facility announced today is exactly the kind of targeted technical mechanism Ben Bernanke himself in a speech several years ago laid out as the suitable Fed response to market upheaval (see "A Surgical Strike" August 17, 2007). In that speech, he made a clear distinction between the appropriateness of such action versus adjustment of the fed funds policy rate, which he said should only be used to meet the Fed's objectives for the macro economy. The problem is that in this episode the Fed has devised a rationalization that treats the market turmoil as a macro risk in itself in order to rationalize caving in to market demands for funds rate reductions, which with yesterday's cut to 4.25% now totals 100 basis points, with more likely on the way.

That the Fed has been groping in befuddlement to locate the right path to dealing with the market's recent torment was underscored by the ham-handed way it came out with today's release. Seemingly, it would have made sense to make the announcement at the same time it released the FOMC statement yesterday. But it was only after seeing the market's response to the 25 bp move (as we predicted -- see "Rescue Rangers" December 10, 2007), with equities crumbling and bonds moving to up the ante on the extent of additional cuts, that it leaked word last night that additional steps to provide liquidity likely were on tap. It's difficult to imagine the Fed under the direction of Paul Volcker or Alan Greenspan operating so clumsily.

Confidence in the Fed was not enhanced either with yesterday's rate cut announcement. One has to wonder how much of yesterday's negative reaction in markets was due to what the Fed actually did, and how much to the confused and confusing way in which it has signaled and explained it. Now, in the space of less than a month, the Fed has made the transition from signaling that it was on hold, to suggesting that market conditions might compel another rate

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cut, to effecting that rate cut Tuesday without any pretense of signaling that an end to the cycle is in sight. Despite the vague and shallow rationalizations in its statement about slowing growth and "some softening in business and consumer spending," it's difficult to avoid concluding that acquiescing to market expectations currently is what the Fed is all about -- especially as the statements about weakness flatly contradict the views we hear privately from highly placed Fed sources (see "'Act As Expected'" November 28, 2007). We think it's no coincidence that the changed tone of Fed officials regarding the policy outlook came as futures markets, after the middle of last month, steadily upped the odds favoring another easing move. With the Fed so focused on the extent of market turmoil, market players know the Fed was not going to risk disappointing expectations -- so they have the central bank eating out of their hands right now.

For now, the Fed has its excuse at the ready. "Recent developments, including the deterioration in financial market conditions, have increased the uncertainty surrounding the outlook for economic growth and inflation," according to the FOMC statement. In this way, policymakers hope to maintain the patina of credibility for their head-long slide back toward an excessively easy posture. But the Fed did its credibility no favors by avoiding a risk assessment in yesterday's statement for the second time in the three meetings since the present credit market crisis broke out. The absence of an assessment of whether growth or inflation is the primary concern at this point says they don't want to be on record taking a position that they will be accountable for.

In this way, the Fed is itself helping to sow the uncertainty that it claims it is seeking to dispel. A compelling glimpse into the dynamics at work was provided yesterday with release by the National Federation of Independent Business of its small business optimism index. For the second consecutive month, the NFIB cited the Fed in reporting a decline of the index, which is now at 14-year lows (see "Fear Itself" November 16, 2007). "Things were looking good on Main Street until the Fed warned that the economy was at risk of sinking," said NFIB's William Dunkelberg. At the same, though, while the optimism of small business owners is down due to the spreading negative sentiment which is deepening with the Fed's assistance, the survey shows little change in specific plans of the entrepreneurial sector. The percentage of firms planning to expand was at 13% in November, versus 14% in October and a third-quarter average of 14%. Firms planning to hire were unchanged at 11% last month, down slightly from 14% in the third quarter. The biggest change was in the net percentage of firms expecting the economy to improve, which was at -10%, down from -2%, which essentially is a quantification of building negative sentiment.

This disparity in the small business community between sentiment and actual on-the-ground circumstances is telling. It's consistent with our observation that the fear spawned by the credit market crisis has been fanned far and wide, but that the impact to date on actual economic conditions has been minimal. The persistence of pessimism and uncertainty could itself end up exerting a significant drag on growth, but it doesn't seem to have done so yet. Also worth noting: 7% of firms in November reported that credit was harder to get, just a touch above the 6% in October. "Credit conditions continue to look normal," said NFIB. "There is no credit crunch on Main Street," Dunkelberg said. "All the angst appears to be confined to Wall Street and its observers." And, unfortunately, the Fed.

Meanwhile, the price of gold today moved sharply higher in the wake of the Fed's announcement of a new global lending facility, before settling into a range around $815. The Fed has already been in an aggressive course of liquidity injection consistent with its assertive rate-cutting posture, and today's announcement -- which specified at least another $40 billion in transactions -- figures to compound the liquidity excess. Were the Fed not already committed to maintaining a bounteous supply of funds through its New York open market desk, today's announcement could have been handled in such a way that it wouldn't necessarily have meant a net addition to liquidity. But it seems unlikely the desk will be reducing the volume of its transaction to offset the funds being provided through the new facility. Moreover, although the auctions specified today are for relatively short terms, it's unlikely in this environment the Fed will let them roll off without replacing them. So the announcement represents a significant net increase in liquidity supply for the foreseeable future.

The unveiling today of a new lending facility by the Fed could have gone a long way toward resolving the credit market tangle -- had it been put in place in a timely manner earlier in the crisis. As it is, though, it comes only after the Fed has already sanctioned 100 basis points in rate cuts, putting it in a deep excess liquidity posture, and with more rate cutting in all probability on tap. For now, the Fed and most analysts are content to tell themselves that the statistical price indexes indicate there's little reason for concern about potential inflationary consequences. The official indexes, however, are the most backward-looking of all data in the statistical arsenal, and they are plainly refuted by forward-looking market prices which tell us that a significant inflation breakout is in store. The major remaining question about that breakout surrounds its timing, but it's plausible to think that within the next 12 to 18 months the Fed will be compelled to enter an aggressive rate hiking campaign, which could end up sharply limiting the upside to growth coming out of the current deceleration in the pace of expansion.

BOTTOM LINE: Though the Fed cut rates by 25 bp instead of 50 bp, nothing in the FOMC statement or in this morning's announcement of a new global funding facility gives markets any reason to stop bullying the Fed to cut rates even further. The disorganized way in which the Fed coordinated yesterday's and today's actions reveals its confusion and weakness, and will embolden the markets that have the Fed effectively under speculative attack.