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FED SHADOW

# A Surgical Strike

Friday, August 17, 2007

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**The Fed cleverly addressed the needs of beleaguered markets, without launching new helicopter drops of money on the broad economy.**

| **Update to strategic view** |
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| **FED FUNDS:** Today's discount rate cut was a clever response to the current turmoil, acting to relieve the liquidity squeeze without sanctioning an outright policy change. This will likely have the effect of restoring a degree of market confidence that will bring about a return to normal market function and obviate the need for outright easing. |
| [see Investment Strategy Dashboard] |

The Fed's decision today to cut the discount rate by 50 basis points -- while leaving its funds rate target in place at 5.25% -- amounts to a surgical strike aimed at relieving the market's illiquidity without effecting an actual change in policy stance. This supports the view we expressed yesterday, that while the Fed is under pressure to relieve beleaguered markets, it should not and does not wish to cut the fed funds rate (see "2007 and the Ghosts of 1998" August 16, 2007). In fact, the Fed's choice to act through the channel of discount window lending *reduces* the likelihood that it will end up responding to the current market turmoil with an outright policy change, recognition of which is reflected in the decline today in the fed funds futures market.

The Fed's approach can be seen as distinguishing between the crisis of confidence which has brought on the present liquidity crunch and a fundamental scarcity of liquidity which would necessitate an easier policy stance. While the Fed today in its statement recognized that risks to growth have "increased appreciably" due to the financial turbulence, those risks are likely to be resolved positively if today's action has the effect of stanching the market's panic attack. Judging by the initial market response, with a broad range of indicators suggesting the beginnings of relief from the extreme risk abhorrence seen in recent days, we think there's a very good chance this move will have the desired result.

It's worth noting in the midst of this market maelstrom that all signs suggest the economy remains on solid ground. Key indicators released this week showed continued strength in retail sales and industrial production. So-called "core" retail sales -- excluding building materials, autos and gasoline -- show three-month annualized growth of nearly 8%, the best since early last year. Similarly, manufacturing production is up at a three-month annualized rate of nearly 5%, the strongest in nearly a year. While these data are necessarily backward-looking and don't reflect any consequences of the most recent market events, neither do they support the notion that any of the financial upheaval can be tied to incipient economic softening. Yes, there was more bad news on the housing front this week, with starts falling to the lowest rate in a decade.

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But the housing slump is old news and not likely having much fresh impact on trading at this point.

While obviously the inflation issue is taking a back seat amid this crisis atmosphere, the Fed likely took its action today on the discount rate -- rather than as an outright policy ease -- at least in part because it did not want to signal that it's letting down its guard on the upside risks to the price level. The indicators we watch most closely, including gold and the dollar, have responded to the flight to liquidity as one would expect -- with the dollar appreciating and gold falling, though in neither case by amounts that would seem commensurate with the panic seen elsewhere in markets. Already today, though, a non-negligible part of that movement has been reversed, with gold climbing back toward $660 having traded below $645 in overnight trading prior to the Fed's move. At this point, we still cannot rule out the possibility of a near-term Fed rate cut if market conditions do not stabilize sufficiently over the next few weeks. That would most likely come to be seen as an interim step, however, as we continue to think it is highly likely that the Fed will at some point face the inevitability of resuming its rate-hiking exercise in response to inflation rising to higher than tolerable levels.

**BOTTOM LINE:** The discount rate cut today was a clever response to the current turmoil, acting to relieve the liquidity squeeze without sanctioning an outright policy change. We see it as likely that the Fed's action will have the effect of restoring a degree of market confidence that will bring about a return to normal market function and obviate the need for an easing of its policy stance.