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Don't Count Your Doves

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Despite a seemingly overwhelming consensus, it's still too early to take rate cuts for granted.

The great debate over whether or not the Fed will be inclined to intervene in the current market upheaval with an outright policy ease probably will no doubt be stimulated when chairman Ben Bernanke speaks tomorrow. But it will move significantly closer to real resolution next week with the release of key data on manufacturing and employment. These indicators, starting with release of the ISM manufacturing index on Tuesday, will offer the first glimpse into the economic fallout -- if any -- from the credit market seizure of the past month.

Bernanke has made it quite clear, most recently in his letter to Senator Charles Schumer (D-NY), that the Fed is prepared to "act as needed" in response to the market's distress. For Bernanke and this Fed, however, that need is specified as the mitigation of "adverse effects on the economy arising from the disruption in financial markets." Unless such adverse effects are manifest -- in the real economy, not the markets -- the Fed is likely to keep the fed funds rate target on hold at 5.25%.

Update to strategic view

FED FUNDS: Markets are priced with absolute certainty of a fed funds cut at or before the September 18 FOMC meeting. We still think that the Bernanke fed won't cut rates simply in response to market stresses, but will wait for solid evidence of slowing in the real economy. Given how markets are priced we see betting against a rate cut as a low-risk speculative opportunity, and given our contrary view, a potentially very profitable one.

[see Investment Strategy Dashboard]

Fixed income markets today are again seeing a flight to safety in the shortest Treasury maturities, apparently in response to a *Wall Street Journal* article laying out apparent differences between the approach being adopted by Bernanke versus that employed by former chairman Alan Greenspan in responding to such market events. The analysis suggests that Greenspan was more sensitive to the economic consequences of a spike in risk aversion as seen, for example, in the financial crisis following the Russian debt default in late summer1998. He was, according to the article, willing to act preemptively rather than awaiting confirmation of the economic impacts in the data.

The flight from risk seen in the 1998 episode, however, was considerably more intense than that being witnessed now (see "2007 and the Ghosts of 1998" August 16, 2007). The late '90s were a tight money period in Greenspan's tenure and, in fact, the effects of the Fed's deflation-biased policy stance -- as seen in falling commodity prices and steady dollar appreciation -- were

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directly implicated in the sharp spike in risk aversion associated with the financial market tumult. The Merrill Lynch high yield spread, for example, which traded at around 260 basis points in spring 1998, spiked by nearly 300 bps to more than 550 bps by the time of the Fed's first rate cut in late September. The current retreat of the market's risk appetite has seen the Merrill spread jump from about 250 bps to a current range around 440 bps. No question, that's a noteworthy shift in risk preference, but current monetary conditions bear little resemblance to those evident during the earlier period. Given that this spread has averaged about 500 bps over the past 10 years, from a broader perspective the recent increase in risk aversion can be seen as a correction for an exaggerated underpricing of risk. The Merrill spread peaked at nearly 460 bps on August 16, the day before the Fed's discount rate cut, and has since traded in a relatively narrow range between 430 and 450 bps. These levels do not suggest a shunning of risk likely to have significantly unfavorable economic consequences.

We do not expect, then, that the data due for release next week will give much support to those clamoring for initiation of an aggressive course of rate cutting. While certain segments of the credit market show severe stress, most notably with commercial paper outstanding having contracted by some $240 billion over the past three weeks, overall access to credit appears to be holding up. Commercial and industrial lending in the most recent 4-week period shows growth at an annualized rate of 30%. That's a marked acceleration from levels around 6% to 9% seen through this past spring. A good part of this lending growth is likely tied to the expansion in capital expenditures that has recently become evident and which should support manufacturing.

The August employment report next Friday is a lynchpin in the hopes of those calling for a course of Fed ease. This morning's uptick in weekly jobless claims is seemingly giving some support to the doves, with claims of 334,000 in the most recent week, up from less than 320,000 in the last three weeks. But in the larger scheme of things, that is no more than normal variation in the data, and at this point there's little reason to think a sudden weakening of the labor market is in the offing.

Bernanke's speech tomorrow at Jackson Hole is being eagerly anticipated for whatever clues he might be prepared to give on his outlook, but we'd be surprised if he goes much beyond the signals that have otherwise been coming from the Fed, It sees increased economic risk arising from the financial market turmoil but is unlikely to act in the absence of evidence that the risk is becoming reality. It's also worth noting that while continuing inflation risks are receiving scant attention in the current environment, the Fed itself is not ignoring these risks. The minutes of the August 7 FOMC meeting released earlier this week referred to the favorable readings on core inflation seen in recent months, but suggested these had been "damped by transitory factors and did not provide reliable evidence that the recent level would be sustained." Bernanke tomorrow might make no more than passing reference to the current inflation climate, but it’s a good bet that he's putting considerable weight on it in his policy considerations.

BOTTOM LINE: Futures markets are priced with absolute certainty that the Fed will be moving to cut rates no later than its next regularly scheduled meeting on September 18, but that conviction could be challenged in a big way next week if the data does not conform to notions that the financial turbulence is giving rise to a period of significant economic slowing. Our analysis suggests that the doves' hopes for evidence of real weakening are unlikely to be realized.