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FED SHADOW

The Fed Gets the Yips

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The Fed caves in to panic, and inflation risk kicks into high gear.

Update to strategic view
FED FUNDS: Yesterday's rate cut moves the Fed to an outright easy policy posture, and unleashes new inflationary pressures reflected in moves in oil, gold, forex and the Treasury curve. While not formally adopting a strict growth bias, the tone of the FOMC statement opens the door to another rate cut in October, which is probably too soon for sufficiently convincing evidence of economic strength to materialize. That said, we don't believe that the data will end up supporting a long-lived rate-cutting cycle, and fixed income markets pricing for such hopes are likely to be disappointed.
[see Investment Strategy Dashboard]

In a move that risks eventually squandering the credibility it has painstakingly built up over the past three decades, the Fed yesterday caved in to the "sky is falling" crowd in making a 50 bp cut in both the Fed funds and discount rates. We had expected only a 25 bp cut in the funds rate (see "Bad Jobs" September 7, 2007). The FOMC determined that "the tightening of credit conditions has the potential to intensify the housing correction and to restrain economic growth more generally." That "potential" was deemed sufficient to take preponderance over the "predominant concern" with inflation cited just over a month ago in the Fed's previous policy statement, which in maintaining the FOMC's hawkish bias, also cited the fact that a "sustained moderation" in inflation had yet to be "convincingly demonstrated."

We'd be much more heartened by the enthusiastic equity market response to the move were it not accompanied by clear-cut signals across the spectrum of market prices that the Fed is significantly intensifying the inflationary influences that have long been evident in its extended period of monetary accommodation. As we warned would happen as we contemplated the risks of the FOMC going too far yesterday, after the announcement gold moved to 27-year highs, oil moved to all-time highs, the dollar moved to all-time lows against the euro and the trade-weighted basket of major currencies, and the 2-10 Treasury yield curve blew out by 11 bp to 50 bp (see "Did Somebody Say 'Inflation'?" September 13, 2007). For now, the rate cut is an accelerant for stocks, as we said it would be (see "Cut or No Cut" September 5, 2007). But the behavior of inflation-sensitive markets raises the real prospect that the price stability consequences of the Fed's departure from an inflation-first focus will, in the long run, precipitate a policy response putting stocks in considerable jeopardy along with the sustainability of this economic expansion.

As we expected, the FOMC did not adopt an unambiguous bias toward growth risk in yesterday's statement, offering nothing comparable in clarity to its former characterization of

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inflation as the "predominant" risk (see "A Dearth of a Thousand Cuts" September 18, 2007). In fact, the FOMC declared, in a seeming nod to symmetry, that "it will act as needed to foster price stability and sustainable economic growth." That said, the overall tone of the statement was unmistakably colored by an overriding concern with risks to growth. We were especially struck by the notably unconfident characterization of the rate cuts as "intended to help forestall some of the adverse effects on the broader economy…" *Help forestall* -- not forestall? *Forestall* -- not prevent? *Some* of the effects -- not all of them? The choice of such tentative and unreassuring words could easily be taken as suggesting that the Fed implicitly assumes that further rate cuts will be necessary as the situation inevitably worsens. So while strictly speaking the Fed has kept all its options open, further action, perhaps as soon as the October 31 meeting, certainly cannot be ruled out -- as much as we may believe that such action is unnecessary and ill-advised.

Following yesterday's statement, futures markets on rate expectations quickly impounded an additional 25 bp in rate cuts at all points through the first quarter of next year, compared to what they had previously priced. A similar thing happened in 1998 when the Fed started cutting rates in response to the credit crisis triggered by the collapse of Long Term Capital Management -- the more the Fed cut rates, the more additional cuts the market expected (see "2007 and the Ghosts of 1998" August 16, 2007). Then, as it turned out, only three cuts totaling 75 bp were indeed implemented, and the expectations for cuts beyond that were ultimately proven wrong. While there may well be another cut to come in the short term, we expect that now, as then, the arrival of stronger than expected growth data will put an earlier than expected halt to what is now widely thought to be a sustained new rate cutting cycle.

BOTTOM LINE: With Tuesday's 50 bp reduction of the funds rate to 4.75%, the Fed's marginally accommodative posture has been restored to outright ease, as confirmed by the array of inflation-sensitive market indicators tracking the purchasing power of the unit of account. The Fed kept its options open -- which means on the one hand that the Fed did not unambiguously signal the onset of a sustained rate-cutting cycle, but on the other hand there was no hint that the larger-than-anticipated cut a "one and done" move. What happens now will depend on the economic outlook, and our view remains that the economy with weather the recent market turmoil without a significant setback. It's not clear, however, that there will be convincing enough evidence of that by the time the Fed next meets on October 31.