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The Fed In a Box

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What can the Fed do when markets and the media expect Armageddon -- but there's no evidence for it?

Update to strategic view
US BONDS: The Treasury curve is discounting an economic Armageddon that is highly unlikely, and that the Fed doesn't see happening. At least one more rate cut is virtually certain, but bonds are priced for many more cuts, and are very vulnerable to considerable losses when those expectations prove to be exaggerated.
[see Investment Strategy Dashboard]

Alternating phases of angst and relief gripping the capital markets these past few months have been etched in the bond market this week like an unstable heart patient's electrocardiogram. Monday saw the peak of panic, with the short end of the Treasury yield curve dropping to levels indicating that as much as 175 basis points in rate cuts could be in store. Over the next two days, yields bounced sharply higher in accord with an appreciable unwinding of the panic premium. Today we're seeing another screaming rally across the yield curve on some marginally weakish economic data, with short issues pricing for the Fed remaining in rescue mode for the foreseeable future.

That might be an exaggerated extrapolation of Fed vice chairman Donald Kohn's dovish message yesterday, but Kohn no doubt meant to convey the Fed's willingness to continue satisfying the market's quest for central bank succor "as needed," at least for now (see "'Act As Expected'" November 28, 2007. Kohn's comments led to a considerable relaxation of the panic premium, as seen in a strong equity market rally, a narrowing of credit spreads and a sharp pop higher in Treasury yields. Conceivably, if the markets maintain such an appearance of stability, the Fed could be disinclined to sanction another rate cut at its December 11 meeting. But in this environment the Fed is likely to be most attentive to avoiding any negative market fallout. That almost surely means that if market expectations are priced for a Fed cut, the Fed will cut. At this moment, in fact, Fed funds futures are not only fully discounting one 25 bp cut, they're showing a better than 30% chance of a 50 bp cut. There is not a single instance in history when such intense expectations two weeks before an FOMC meeting proved to be wrong.

This is the box the Fed has put itself in with its response to the credit market turmoil since the summer, where by caving to the market's worst fears, it has left itself little choice but to continue placating those fears (see "The Fed Gets the Yips" September 19, 2007). Although it was little noted in coverage of Kohn's remarks yesterday, he actually indicated that he understands that this market "crisis" is one that shows little sign of having broader economic consequences. "In general, nonfinancial businesses have been in very good financial condition," Kohn said.

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"Outside of variable-rate mortgages, households are meeting their obligations with, to date, only a little increase in delinquency rates, which generally remain at low levels." In other words, there's very little to suggest the subprime-centered upheaval is spreading to non-mortgage-related activity. Nevertheless, Kohn noted that the increased turbulence of recent weeks "partly reversed some of the improvement" last month and in September, and posited that should the "elevated turbulence persist, it would increase the possibility of further tightening in financial conditions for households and businesses." Growing concern about larger losses at financial institutions "have depressed equity prices and could induce more intermediaries to adopt a more defensive posture in granting credit, not only for house purchases, but for other uses a well." There's no evidence that any of this is actually happening, but the "possibility" that it "could" serves as a handy rationalization for an easy-money Fed that is actively contemplating becoming even easier.

In pursuing this course the Fed has an eager handmaiden in the mainstream media, which can usually be counted on to offer the worst case economic view. As we suggested recently, one of the biggest risks the economy is currently facing is that widespread economic pessimism becomes self fulfilling (see "Fear Itself" November 16, 2007), and there's no question that the media plays a big role in sustaining the negative sentiment. The lead story in today's *New York Times*, for example, is headlined, "Lenders Tighten Credit; Growth At Risk." The scare story begins: "Credit flowing to American companies is drying up at a pace not seen in decades, threatening the creation of jobs and the expansion of businesses, while intensifying worries that the economy may be headed for recession." As support for this proposition, the story states that "the combined value of two leading sources of credit -- outstanding commercial and industrial bank loans, and short-term loans known as commercial paper -- peaked at about $3.3 trillion in August….By mid-November, such credit was down to $3 trillion, a drop of nearly 9%." What the piece doesn't acknowledge until much deeper into the story is that this decline is entirely explained by the asset-backed commercial paper market which -- as has been reported far and wide for months -- suffered a considerable contraction in the subprime meltdown. Commercial and industrial lending is continuing to grow, posting another record high of more than $1.4 trillion last week, and expanding at an annualized pace of about 25% the past two months.

Were the Fed able to dispense its largesse without incurring potentially significant longer-term costs, we would have no problem with it. Who could object to making as much money as easily available as possible to as many as possible under any circumstances? The problem is that ultimately there's a price to be paid, and the indicators we follow most closely -- including gold near all-time highs and the dollar near record lows -- suggest that the price will ultimately prove substantial in terms of higher inflation and the policy response that will be required to contain it. We understand that there are Fed officials who have serious concerns about the inflationary consequences of the current policy course. At this point, though, those concerns are taking a back seat to the predominant objective of providing the markets -- and the media -- with all the assurance they need that the Fed is on their side.

BOTTOM LINE: The Treasury yield curve is now priced for another 150 basis points in rate cuts, and the Fed futures curve indicates that as much as 100 bps of that could come by next spring. We'd be strongly inclined to bet against that, but at the same time we have to acknowledge that given the easy money proclivities demonstrated by the Fed the past few months, we can't entirely rule it out. Still, the economic Armageddon now being priced in the bond market seems unlikely to be borne out, and bonds at these levels will be rendered highly vulnerable.