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FED SHADOW

Fed Cred Dead?

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Even as it saves the world, the Fed can't quite get it right.

As we predicted yesterday, the Fed cut interest rates ahead of the scheduled January FOMC meeting in response to the turbulence in global equity markets (see "Another Leg Lower" January 21, 2008). As of this writing mid-morning, opening losses in the US stock market have been significantly pared, and the meltdown implied by limit-down overnight futures trading has apparently been averted. But we can't help but feel that even this much-needed emergency action underscores the Fed's deepening credibility problem and leadership deficit. It shows that when a mighty locomotive like the Fed comes off the rails, it is nearly impossible for it to get back on.

The Fed's action provokes questions that a central bank ought not to want market participants to ask after an action like this. Why was the cut 75 bps, rather than the definitive-sounding round number of 1%? Why was it executed before the opening of the US stock market, condemning the Fed to the inevitable headline "Fed Rate Cut Couldn't Stop Stock Crash"? Why not let stocks open lower, then announce the cut, and earn the headline "Fed Saves the Stock Market"? Why, at a critical moment like this, was FRB governor Frederic Mishkin absent, and how could St. Louis Fed president William Poole be allowed to dissent in the FOMC's emergency decision, when unanimity would have had so much value?

The surest signal that the Fed only diminished its credibility with this morning's action is the response to it in fixed income futures markets. In the wake of the rate cut, as of this writing, futures have upped their expectations for further cuts by anywhere from 37 bp to 48 bp, depending on maturity. For example, at Friday's close, the February futures were discounting the total certainty of 50 bp in cuts by the January FOMC meeting, with a 70% chance of a 75 bp cut. Now that the 75 bp cut has arrived, the same futures are discounting the total certainty of another 25 bp cut at the January FOMC meeting, and a 70% chance of a 50 bp

Update to strategic view

FED FUNDS: With the Fed having delivered a surprise intermeeting 75 bp rate cut, markets are now demanding further cuts at the scheduled January FOMC meeting. Unless a miracle entirely restores troubled credit markets in the next eight days, we have no doubt that the Fed will give the market what it demands.

US RESOURCE STOCKS, GOLD, OIL, COMMODITIES, US DOLLAR: The Fed's emergency rate cut, and the additional cuts the market is now demanding, will add fuel to the inflationary fire. Inflation-sensitive sectors should show the sharpest recovery if indeed a bottom in stocks has been reached, commodity prices should continue to be strong despite poor global growth sentiment, and the dollar should continue to be weak.

[see Investment Strategy Dashboard]

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cut. So as it always seems with the Bernanke Fed, the more the Fed gives the market, the more the market demands of it.

As we hoped yesterday, the Fed seems to have helped stock to "find a bottom." But perhaps just as critical to helping the stock market stabilize was the announcement this morning that the troubled bond insurer Ambac is "evaluating strategic alternatives with a number of potential parties." As we discussed yesterday, we think the proximate cause of the weekend's drop in global stock markets was the risk of spillover effects from the downgrading of the bond insurers, in the face of a deadlock in which their market capitalization has become too small to permit capital infusions without massive dilution of existing holders (again, see "Another Leg Lower"). The risk was highlighted by Ambac's announcement Friday that it was abandoning plans to raise $1 billion in capital, and it has lessened significantly today with the news that the company is exploring other means to the same end. It wouldn't surprise us if the Fed or the Treasury had spent part of the three-day weekend encouraging such explorations.

We also note that the most immediate and tangible market reaction following this morning's rate cut was in gold. Having traded at low as $850 overnight, it had already recovered to about $865 by the time of the Fed's announcement. Immediately upon the news, while stocks and Treasuries reacted uncertainly to the 75 bp rate cut, gold immediately rallied to $875. As of this writing it's at $891, up $26 on the day. This tells us one thing loud and clear. Whatever else the Fed's emergency rate cut may do for stocks, bonds, the credit crisis or the economy, it will have an inflationary cost. There's no such thing as a free lunch. And there's no such thing as a free bail-out, either. Inflation is the price of this one.

BOTTOM LINE: With the Fed having delivered a surprise intermeeting 75 bp rate cut, markets are now demanding further cuts at the scheduled January FOMC meeting. Unless a miracle entirely restores troubled credit markets in the next eight days, we have no doubt that the Fed will give the market what it demands. The Fed's emergency rate cut, and the additional cuts the market is now demanding, will add fuel to the inflationary fire. Inflation-sensitive sectors should show the sharpest recovery if indeed a bottom in stocks has been reached, commodity prices should continue to be strong despite poor global growth sentiment, and the dollar should continue to be weak.