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Jump! How High? Cut! How Low?

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The Fed's appeasement of market panic has brought us to where further rate cuts may do more harm than good.

Another big Fed rate cut yesterday, and -- what do you know? -- minutes later futures markets priced for even more cuts. *Before* the Fed's announcement of a 50 bp cut in the funds rate from 3.5% to 3.0%, the futures markets were giving that cut about a 70% probability, with only a 30% probability of another 50 bp at the March FOMC meeting (a 25 bp cut at each meeting was deemed a certainty). Immediately *after* yesterday's cut, the probability of a 50 bp cut in March advanced to a 60%, and closed the day at 90%. This morning, with a surprisingly large rise in initial jobless claims reported -- never mind that the seeming rise was due *entirely* to seasonal adjustments -- rate cut expectations for March have now advanced to certainty for 50 bp, with a 50% probability of 75 bp. This has been a consistent pattern in the present rate-cutting cycle, beginning with the 50 bp cut that inaugurated it on September 18, 2007 (see "The Fed Gets the Yips" September 19, 2007). Throughout, the more the Fed gives, the more the market immediately demands -- and the more the market demands, the more the Fed gives.

Update to strategic view
US STOCKS: Solutions can be found for the few lingering elements of the credit crisis. Rates are so low, and stocks are so cheap with forward earnings ex-financials at all-time highs, stocks ought to be able to tolerate short-term news shocks without breaching last week's panic lows, and to sustain a meaningful recovery. But with the Fed hell-bent on more rate cuts even in the presence of increasingly obvious inflation risk, we are increasingly worrying about long-term negative consequences.
[see Investment Strategy Dashboard]

In one sense this could be interpreted as the Fed's failure to get ahead of the unfolding sequence of crises that have characterized the present period of turbulence in credit markets. Just as a century ago in the banking panic of 1907, there has been a series of related yet separate risk episodes, each springing up like a new leak in the same dam, and each one somehow repaired -- yet always another one seems to appear. In 1907 there was no single definitive solution that ended the panic -- the dam finally just ran out of leaks, and fortunately it was before J. P. Morgan ran out of plugs. This panic will doubtless end the same way eventually, but now the plugs are not being provided by Morgan herding a disorderly group of balky bankers. A century later, the Federal Reserve is expected to plug all the leaks with its inexhaustible supply of monetary liquidity.

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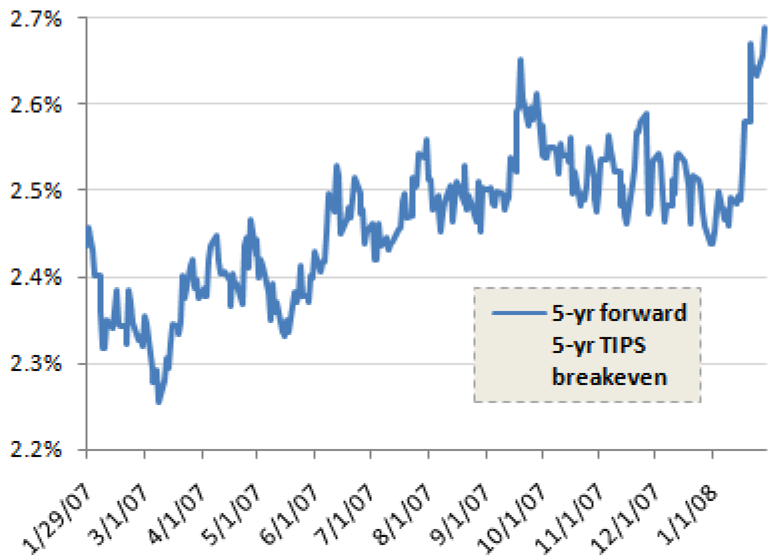
And so the Fed -- despite its dual mandate of maximum employment and stable prices, a mandate that says nothing about stabilizing market turbulence -- finds itself in the embarrassing position of having its policies almost entirely determined by market turbulence, arising for whatever reason or no reason. Last week's convulsion in global equity markets may have been due largely to an entirely technical event -- the panic liquidation of Société Générale's enormous futures positions established by a rogue trader. Yet having not been informed about the liquidation, and having virtually promised to cut rates at the January FOMC meeting, the Fed had little choice, as we predicted, but to intervene forcefully with a 75 bp inter-meeting cut (see "Another Leg Lower" January 21, 2008). In the aftermath, with the fact of SoGen's liquidation having come to light and the Fed's emergency response looking as though it had been motivated in ignorance of the true nature of events, the Fed leaked to reporters that it had planned on an inter-meeting rate cut anyway. It's a revealing confession of the Fed's own sense of its damaged credibility that it would find it necessary to issue this lame self-justification, when one would think it should be sufficient to say that there was a global market panic and the Fed responded to it -- period (see "Fed Cred Dead?" January 22, 2008). But *this* Fed is intent on keeping up the appearance that it is not simply appeasing the demands of markets, but rather trying to "mitigate the risks to economic activity," as the FOMC put it in yesterday's post-meeting statement.

But appeasing it is. And the problem with appeasement is that there is no way to stop appeasing once you have begun. No sooner had the FOMC announced its rate cut yesterday than a whole new crop of crises appeared, as if on cue -- or at least some slightly new variations on the already well known issue of the ratings status of the bond insurance industry, and of the CDOs held by investment banks. The CDO matter is real. But at this point it's hardly new or unexpected. And the matter of the bond insurer's ratings is indeed a difficult problem (again, see "Another Leg Lower"). But unlike the abortive attempts last year to prop up the failed SIVs, in this case there are enormous gains to be had by large external constituencies in preserving the insurers' ratings, and a significant risk-pooling arbitrage that can subsidize potential solutions. One viable approach would be to create a reinsurance fund capitalized by existing customers and distress investors. It *can* be done. Yet such a solution is not likely to be particularly facilitated by a funds rate any lower than the 3% we've already got now. Yet the re-emergence of the bond insurer crisis yesterday afternoon was inevitably framed in the context of yesterday's rate cut, and thus it fit perfectly into the *zeitgeist* that treats further cuts as a necessary precondition for solving virtually any problem.

Let's be generous and give the Fed the benefit of the doubt. Its targeted operations such as the Term Auction Facility seem to have been effective at meeting the global banking system's urgent needs for interbank liquidity. And its more generalized supplying of liquidity to the overall economy through lower interest rates has arguably been effective, too -- credit remains widely available throughout the banking system, the financial sector has had no problem replenishing its impaired capital (see "Rescue Rangers" December 10, 2007), and there are remarkably few signs of substantive economic slowing, especially given the intense pessimism abroad in the land (see "Soft Spot, Not Armageddon" January 17, 2008). But from here, it's highly debatable how useful further rate cuts are likely to be. Yet they will surely be costly -- in terms of inflation.



The fusillade of rate cuts we've had so far has already awakened inflation risks in profound and disturbing ways. After yesterday's rate cut, gold -- the supreme indicator of inflation risk -- made new all-time highs. The US dollar fell to within basis points of all-time lows on a trade-weighted basis. Even the normally quiescent TIPS spread has started to flash warning signs. The 5-year TIPS spread on a 5-year forward basis -- the Fed's most preferred indicator of inflation expectations -- has broken out to new highs following the Fed's emergency rate cut of last week. Other than financials, the inflation-sensitive materials and energy sectors have been the best-performing off last week's panic bottom. And yesterday's GDP report, while unremarkable in most ways concerning growth, revealed inflation kicking up dramatically in the fourth quarter of last year. The GDP deflator rose 2.5% in the fourth quarter, up from 1.0% in the third; and the personal consumption expenditures deflator rose 3.9% in the fourth quarter on an annual basis, up from 1.8% in the third. Based on the latter, with the fed funds rate at 3.0%, real rates are now negative. Under what cost-benefit calculus should the Fed consider cutting any further?

BOTTOM LINE: Solutions can be found for the few lingering elements of the credit crisis. Rates are so low, and stocks are so cheap with forward earnings ex-financials at all-time highs, stocks ought to be able to tolerate short-term news shocks without breaching last week's panic lows, and to sustain a meaningful recovery. But with the Fed hell-bent on more rate cuts even in the presence of increasingly obvious inflation risk, we are increasingly worrying about long-term negative consequences.