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FED SHADOW

No Pause Promise, But No Panic

Thursday, May 1, 2008
Donald Luskin

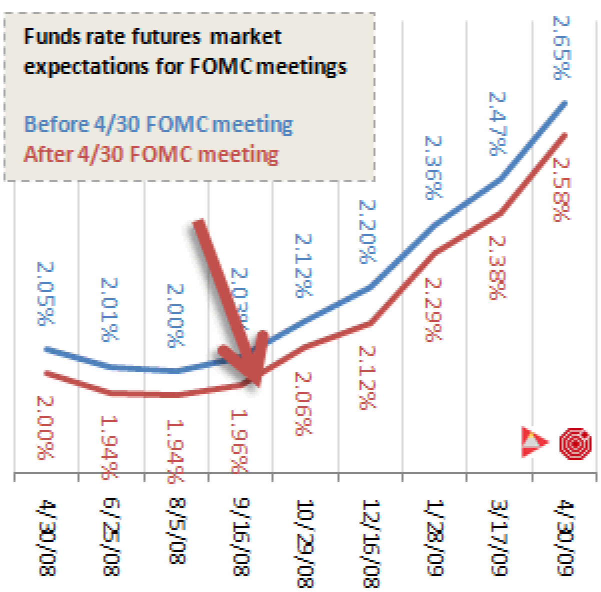
The FOMC was disturbingly vague -- but the finger is off the rate-cut trigger.

At first blush, it seemed that yesterday's 25 bp fed funds rate cut and the FOMC's post-meeting statement were a step in the wrong direction for the Fed. Going into the announcement, futures markets were priced for only an 80% probability of a cut, and an increasingly skeptical financial community was looking for some explicit indication that the Fed intended to at least pause the present rate-cutting cycle (see "FOMC Preview" April 29, 2008). The rate cut gave the markets more than they expected, and on the surface at least, the statement provided very little visibility on the Fed's intentions going forward. The immediate reaction in markets was telling -- fed funds futures immediately repriced to reflect a new possibility of further rate cuts, whereas for the last week or so they had been clearly priced for "one and done." An 80% probability of a rate hike by year-end had been priced coming into the meeting, and afterwards it fell to less than 50%. It was a replay of the same pattern we've seen over and over during the credit crisis, in which the Fed would slavishly exceed market expectations for rate cuts, only to see those expectations immediately become even greater (see "Jump! How High? Cut! How Low?" January 31, 2008).

Update to strategic view

FED FUNDS: Yesterday's FOMC statement was disappointingly vague, but we think the Fed is done. The edge of panic about growth is out of the Fed's rhetoric -- but inflation concerns are becoming deeper. The *force majeure* rationales for dangerously low interest rates won't stand scrutiny much longer.

[see Investment Strategy Dashboard]



How different from the last FOMC meeting on March 18, when just a day after the Bear Stearns panic the Fed had the courage to disappoint the market by cutting the funds rate only 75 bp, when more than 100 bp had been expected (see "Three Quarter Profile In Courage" March 19, 2008). When the Fed dared to disappoint market expectations, those expectations immediately reduced. Just before the March meeting, futures markets had been

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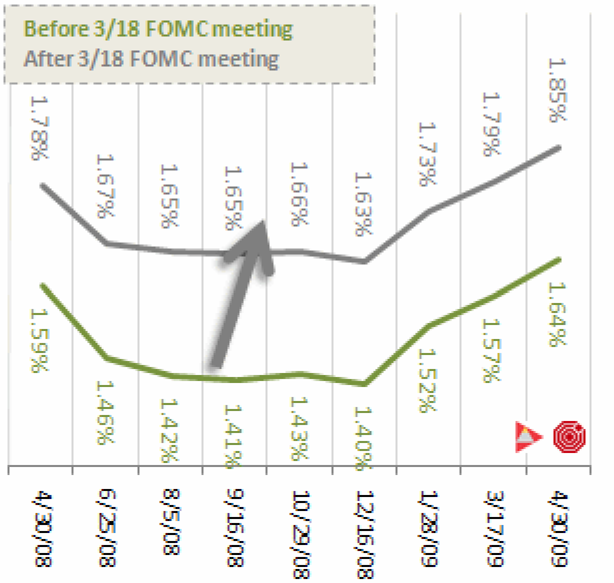
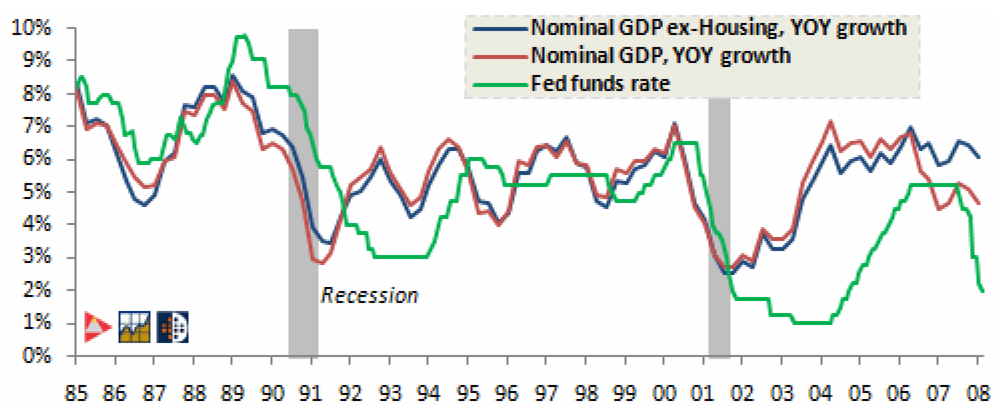


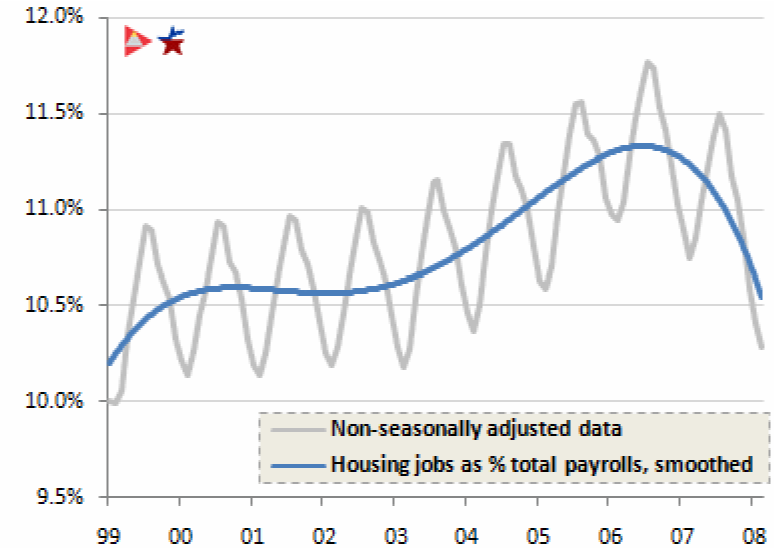
priced for a 60% probability of a 75 bp cut at the April meeting, and a funds rate below 1.5% by mid-year. After the meeting, almost 25 bp came out of those expectations -- and by the time the FOMC made its decision yesterday, expectations for a year out had been scaled back by more than 80 bp. The market came to realize that the Fed's new targeted liquidity tools, especially the Primary Dealer Credit Facility, could substitute for continued reckless cuts the funds rate, an inflationary monetary solution to a credit crisis that had never been a monetary problem in the first place. It restored confidence all around. Since just before the March 18 meeting, stocks have rallied 8.7%. And the most inflation-sensitive markets have cooled, with gold falling 13.2% and the trade-weighted dollar rising 2.4% (see "Inflation Inflection" March 25, 2008). Yesterday was the opposite in every respect -- the Fed more than met market expectations for a rate cut, and those expectations expanded; stocks fell; gold rallied and the dollar declined. Yesterday's FOMC statement didn't even mention the success of the Fed's new tools, leaving markets wondering whether the Fed actually understood how much more effective they were than rate-cutting. If the Fed had earned a little of the market's confidence in March, it seems it gave some of it back yesterday.

But overnight that initial reaction seems to have reversed in some respects -- stocks are up, gold is trading sharply lower, and the dollar is trading sharply higher -- perhaps based on a more careful reading of yesterday's FOMC statement. True, there was nothing like an explicit commitment to pause the rate-cutting cycle (and certainly no commitment whatsoever to halt it, or reverse it). Nevertheless, the statement could be read as hinting that the Fed's previously alarmist view of downward momentum in the economy has moderated, and that it is therefore unlikely to long sustain interest rates at today's extremely low levels on grounds of *force majeure*. In the March statement, the FOMC stated that the economy "has weakened further," but it said in yesterday's statement only that it "remains weak." Previously the FOMC had included the phrase "downside risks to growth remain," but that phrase was absent yesterday. Previously, the FOMC had committed to act against risks "in a timely manner," but that phrase was absent yesterday, too. Replacing those indicia of urgency was a calming new phrase, the commitment to "continue to monitor economic and financial developments."

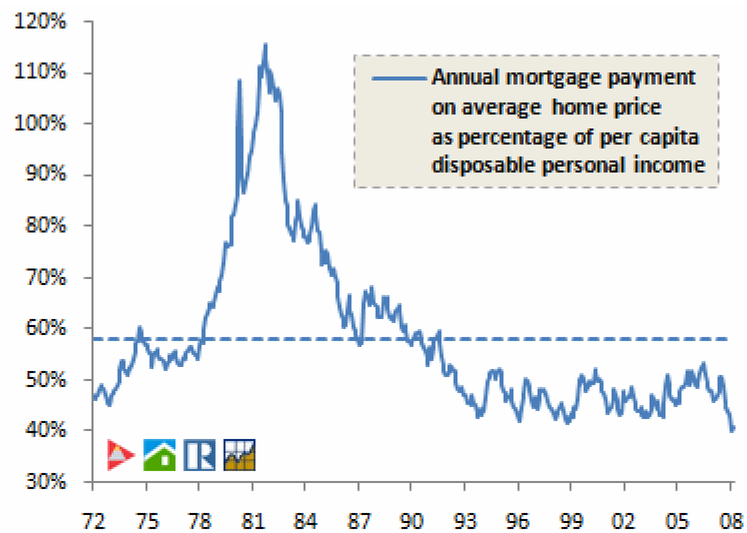


While yesterdays' statement was more relaxed on the growth front, it showed a slightly increasing concern about inflation. In particular, the statement raised the issue that "readings on core inflation have improved somewhat" while, at the same time, "energy and other commodity prices have increased, and some indicators of inflation expectations have risen." While the Fed still has a long way to go toward recognizing the full scope of the inflation problem its excessive rate cutting over the last nine months has created, at least it's a sign of progress that it is learning to look beyond the false reassurances of core inflation statistics.

In light of the Fed's diminished urgency about economic risk reflected in these rhetorical evolutions, it's worth stepping back and appreciating just how extraordinarily low interest rates already are. At 2%, the funds rate is low by any historical benchmark in this generation, other than the period of even lower rates in 2003 and 2004 that sowed the seeds for the credit and housing boom-and-bust from which we're now trying to recover. That's true not only in terms of the absolute level of the funds rate, but also in terms of the relationship between the funds rate and the growth rate of nominal GDP (please see the chart on the previous page). Throughout both of the last two recessions, the funds rate was higher. The funds rate is even more out of whack if the housing sector is backed out of nominal GDP.



In other words, the economy will have to get substantially worse to justify the rate cuts the Fed has already put in place. Will it? We don't think so. We think the credit crisis is over, and that financial markets are on the mend (see ["The Bear Stearns Bottom: One Month Later"] April 17, 2008). And as for housing -- surely the Fed's biggest worry in the real economy -- it's getting to the point where it's hard to imagine that things could get much worse. With yesterday's GDP report, we now have nine consecutive quarters of decline in the residential investment sector, with eight of them in double digits and the most recent the worst of all (at -26.7%). Residential investment now accounts for only 3.4% of GDP, down from 5.5% in 2005. The smaller the sector gets, the smaller its remaining impact on the rest of the economy can possibly be. Housing and real estate jobs (broadly construed) have already fallen from their 2006 peak by about 1.5 million. As a percentage of non-farm payrolls, they have fallen all the way back to where they were in 2000 and 2001, well before the housing boom-and-bust cycle was ignited.



Finally, while it is alarming how much home prices have fallen from their recent highs -- and as solid as is the consensus that prices have much further to fall -- there's actually sound economic logic to argue that we might be at or near the bottom. As hard as it may be to believe for all the panic, the reality is that the panic itself has restored housing to affordability -- and in a big way. Thanks to the combination of falling prices, low interest rates, and rising incomes, today a year's mortgage payments on an average-priced home consumes a smaller percentage of per capita disposable income than at any time in more than 35 years (as far back as data is available). There is no iron law that says that housing can't get more affordable still, but we're now at the point at which the burden of proof is starting to shift to the pessimists. We're surely closer to the end of the housing sector's depression than to the beginning.

With the worst fury of the housing storm possibly already spent, and the credit crisis healing, it's no wonder that the edge of panic and urgency about growth is coming out of the Fed's rhetoric. We think that economic data will continue to surprise on the upside, even if only by not being anywhere near as bad as the consensus expects. So it won't be long before the Fed has to reverse some of the panic-driven *force majeure* rate cuts of the last nine months.

BOTTOM LINE: Yesterday's FOMC statement was disappointingly vague, but we think the Fed is done. The edge of panic about growth is out of the Fed's rhetoric -- but inflation concerns are becoming deeper. The *force majeure* rationales for dangerously low interest rates won't stand scrutiny much longer.