Trend Macrolytics, LLC
Donald Luskin, Chief Investment Officer
David Gitlitz, Chief Economist
Thomas Demas, Managing Director

FED SHADOW

How Tough is Ben's Tough Love?

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David Gitlitz

The Fed has eschewed bailouts. Can the FOMC resist a pointless rate-cut today?

No doubt at least a significant faction of policymakers gathering for today's FOMC meeting will be firmly inclined to deploy the rate-cut option in response to the current financial market upheavals. Fed funds futures are more than fully priced for one 25 bp cut, and prominent voices in the market are calling for as much as 50 bp.

Pivotal to the Fed's decision will be the analysis, particularly by chairman Ben Bernanke, as to whether the crisis is largely a self-contained financial market event or has more broadly damaging economic implications. By this point, one would think that senior Fed officials have come to understand that rate-cutting is no salve for the credit market's ordeal. With its creation of several special liquidity facilities to expand access to the discount window -- and the weekend liberalization of the collateral required of borrowers to gain discount window funding in response to the Lehman collapse -- the Fed has shown that it appreciates the need to use tools other than inflationary rate cuts to handle the crisis.

Update to strategic view
FED FUNDS: A rate cut today would fail to either ameliorate the present market turmoil, or protect the economy from it -- yet beleaguered markets expect it, and will be disappointed if they don't get it. But after some initial dismay, markets could react very positively to what would soon be understood as a sign that the Fed that has finally found its moorings in sound-money policy, free from moral hazard.
[see Investment Strategy Dashboard]

That said, this weekend the Fed notably did not employ for Lehman Brothers the new tool improvised for the Bear Stearns rescue -- the massive acquisition by the Fed of distressed assets (see "Tough Love for Lehman" September 14, 2008). And the Fed as so far not elected to welcome cash-squeezed American International Group at the discount window, instead calling for Goldman Sachs and JPMorgan to orchestrate a liquidity backstop. So with the Fed expanding the use of some liquidity tools, while at the same time failing to employ the most powerful ones as the market had probably expected, we can't be sure that the FOMC today won't fall back on the discredited notion that another rate cut will somehow help ease the crisis on Wall Street. And there very likely will be voices on the committee arguing that the downside economic risks arising as a consequence of the market turmoil compel an easing response, and they can be expected to cite this morning's negative CPI print, and the recent rollback in commodity prices and appreciation of the dollar as offering assurance that inflation risks need not deter action. We don't agree, on either count.

http://www.trendmacro.com
don@trendmacro.com
dgitlitz@trendmacro.com
tdemas@trendmacro.com

Offices:
Menlo Park CA
Parsippany NJ
Charlotte NC

Phone:
650 429 2112
973 335 5079
704 552 3625

The root of the continuing credit market chaos is a housing market bubble gone bust, which was, in itself, rooted in the Fed maintaining ludicrously low interest rates for far too long, and then moving rates up on a highly "measured" course under which policy was kept accommodative even as rates were rising. Outside of housing, the economy continues to show impressive resilience. In the last three years, real GDP ex-housing has grown at a better-than 3% average rate. And even while the credit markets are under severe stress, the availability of credit has been maintained. Growth in commercial and industrial lending, for example, has slowed, but it remains positive, now showing a 4% annualized gain over the past three months. In the aggregate, C&I loans are near record levels. The kind of lending contraction that would be expected in a serious downturn is nowhere in sight.

Bear in mind that the Fed cut the funds rate by 325 bps, to 2%, to cushion the economy against the impacts it feared would arise from the market disturbance, and in no small part to ease the disturbance itself. Could it really expect another 25 or 50 bp cut at this point to make a difference? In one respect it would likely make a big difference, but not in a positive way. Market-based price indicators such as gold moved away from pricing for a worse-case inflation outlook when, after the Bear Stearns collapse in March and the Fannie-Freddie crisis in July, the Fed did not sanction an outright easing response (see "Three Quarter Profile In Courage" March 19, 2008). If it were to do so now, those indicators could well reverse their recent moves and restore a worst-case inflation bet.

The shifts toward lower commodity prices and a stronger dollar should be kept in perspective. Now at about $780, gold did not reach its current price on the way up in this cycle until last October. At that point it was up more than $100 from its levels in early August, as the market priced for the implications of the Fed's easy-money response to the credit crisis. If gold at today's level less than a year ago was signaling a clear intensification of inflation risk, it's not likely that now, with gold at the same level, that risk has now subsided substantially. Similarly, with its recent strengthening, the trade-weighted dollar has recovered back to its levels of about a year ago. But up to that point, it had never been weaker.

The decline of the crude oil price also probably presents a dilemma for the Fed. On one hand, the falling price will give the Fed some comfort on the inflation front, since it has attributed much of the inflation upswing of the past year to an exogenous spike in oil. At the same time, though, the oil price correction has to be considered a positive for the growth outlook, tending to diminish any perceived need for further rate cuts.

BOTTOM LINE: A rate cut today would fail to either ameliorate the present market turmoil, or protect the economy from it -- yet beleaguered markets expect it, and will be disappointed if they don't get it. But after some initial dismay, markets could react very positively to what would soon be understood as a sign that the Fed that has finally found its moorings in sound-money policy, free from moral hazard.