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TRENDMACRO LIVE!

On the Global Rate Cuts

Wednesday, October 8, 2008
Donald Luskin

Irrelevant and inflationary. Markets need real money now, not "soon."

Update to strategic view
US STOCKS, US FINANCIAL STOCKS: Battered stocks might make a stand here, but not because of the futile and inflationary rate cut implemented overnight. It would be based instead on valuation -- the equity risk premium is now the highest in a generation. The financial sector offers the least compelling valuation of any S&P 500 sector, but its risk premium stands now at the highest level of any point since the onset of the credit crisis over a year ago. **GOLD:** While falling global growth expectations have battered most commodity prices, gold has broken out this morning on the news of the overnight rate cut. With the Fed's balance sheet already ballooning to historic proportions, we continue to see monetary inflation as a powerful threat, regardless of the backdrop of slower economic growth -- and gold remains the best pure play.
[see Investment Strategy Dashboard]

Having signaled in a speech yesterday that a rate cut was under consideration for the FOMC meeting at month-end, Bernanke and the rest of the world's central bankers panicked and cut rates early this morning. It was a trivial and futile gesture, made in the wake of much more substantive government interventions to stabilize markets -- such as the enactment last week of the Troubled Asset Relief Program (TARP), and the yesterday of the Commercial Paper Funding Facility. To Bernanke the rate cut must have seemed to have the virtue of being able to be implemented immediately, while TARP and CPFF have yet to be implemented. And Bernanke must have relished the idea that, through this move, the world's financial authorities could show a unified front, following several weeks of disturbingly disjoint policy maneuvering. But distressed markets are urgently interested in relief that matters, not just relief that is easy for central bankers to quickly get in place (see "Henry Paulson: The Donald Rumsfeld of Bail-Outs" October 6, 2008). Getting much-needed capital from the Treasury in exchange for illiquid MBS would matter. Rolling over maturing commercial paper with the Fed, when no other market exists at the moment, would matter. But when will TARP and CPFF actually start operations? The best estimate is "soon." And what possible difference, in the context of the extraordinary liquidity stresses now afflicting the global banking system, can a lower funds rate make -- especially considering the funds rate has already been trading below the new target of 1.5% for much of the past three weeks?

At the announcement of the rate cut, stock index futures reversed heavy losses to sharp gains -- but at the opening of US markets, stocks were nearly back to the night-session's lows. Gold immediately rallied by $40, punching through the $900 level, despite the assurances in the

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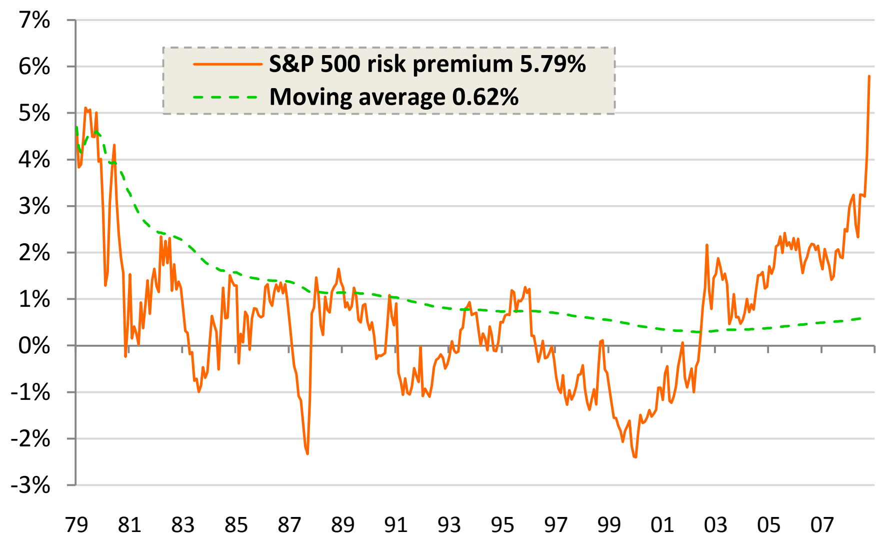
Fed's press release that slowing growth has "diminished further the upside risks to price stability." So for Bernanke's panic, his reward has been the further diminution of the Fed's already tarnished credibility.



As of this writing early in Wednesday's trading session, stocks are stabilizing off their opening lows. Stocks may end up making a stand hereabouts, but it won't be because of this rate cut. It will be because stocks are crazy cheap. The equity risk premium has now risen to the highest level in a generation, a level not seen since the previous instance of a national "malaise," the late 1970s when (among other things) inflation was on the rise and monetary policy was in chaos.

BOTTOM LINE: Battered stocks might make a stand here, but not because of the futile and inflationary rate cut implemented overnight. It would be based instead on valuation -- the equity risk premium is now the highest in a generation. The financial sector offers the least compelling valuation of any S&P 500 sector, but its risk premium stands now at the highest level of any point since the onset of the credit crisis over a year ago. While falling global growth expectations have battered most commodity prices, gold has broken out this morning on the news of the overnight rate cut. With the Fed's balance sheet already ballooning to historic proportions, we continue to see monetary inflation as a powerful threat, regardless of the backdrop of slower economic growth -- and gold remains the best pure play.