Market Volatility and the Federal Reserve

August 21, 2007

Last week's market events have changed our expectation for Fed rate cuts from October to September. After a slow start, the Fed has begun to aggressively deal with a liquidity crunch few have ever seen. However the Fed can do little more from a short term liquidity perspective, after injecting reserves and dropping the discount rate by 50bps. Bernanke is dealing with the reality that tighter financial conditions will affect their expectations for growth, and by extension inflation. Following are three topics for consideration related to the Fed's final and most effective policy tool, the Fed Funds Rate.

First, the Fed has gone out of its way to signal a September easing. At this point, the relevant questions have become, will the Fed will move between regularly scheduled meetings, and will it ease by 25bp or 50bp. 1) The inter-meeting change of the Fed policy bias was a very unusual step, illustrating Bernanke's view that now is the time to move policy towards a neutral bias from a restrictive one. This move also serves to add confidence to the markets that that the FOMC will ensure that weakening economic fundamentals do not turn into something more vicious. If the financial community is re-pricing risk and eliminating it entirely from mortgages, the economic outlook would be substantially worse if growth slows sufficiently that jobs are lost. In that situation, the record highs in foreclosures would only be the tip of the iceberg, and the seizing of liquidity would worsen. 2) The FOMC Policy statement did not even mention inflation and it indicated that, "downside risks to growth have increased appreciably." This timeline is not unlike developments in late 2000 and early 2001. This posturing allows Bernanke to be perceived as being a proactive steward of the economy, as opposed to cutting to bail out investors. The Policy statement had no equivocation and was entirely forward looking, given what has been reasonably solid activity data at mid-year. 3) The Fed action reinforced market expectations that the Fed would have to cut. Not doing so at the September meeting could worsen an already tenuous calm that has settled in since Friday's action.

Second, the Fed would prefer not to move between meetings. Central bankers generally prefer their actions to be seen as controlled and not dictated by events, which shapes their preference only to conduct policy changes at appointed dates. Unlike the 2001 inter-meeting move that initiated that easing cycle, the current economic data is not reflecting a lurch down (recall that Jan 3 inter-meeting cut of 50 bp came days after the ISM plunged to 43), so the FOMC may feel they are more in front of this problem than was the case in 2001. That doesn't preclude a move between meetings; it simply indicates they are predisposed not to ease until a scheduled meeting. If liquidity problems worsen, the shoring up of confidence by Friday's move is unable to restore near term stability, and stocks take another leg down, then the Fed would move ease before the September meeting. There is no reason for the Fed to drag their feet by conducting a policy easing that--they can always take back later--at a time when risks to growth have "increased appreciably"---and at a time when core PCE inflation is within the target range for the first time in several years. At this point, however, odds still favor a cut at the September 18 meeting and not before.

Third, 25 bps or 50bps? Unless financial conditions significantly worse, we anticipate a 25bp move. 1) The Fed sees the current Funds rate changes as part of shoring up confidence and returning policy to neutral. That suggests that policy makers see a high probability of several rate cuts and a low probability of a wholesale slashing of the funds rate. With 75 to 100bp being a reasonable number for the likely overall ease, the Fed will not want to spend 50bp so soon and then reinforce expectations that even deeper cuts in the funds rate are likely. While a 50bp move would be a dramatic statement, putting the Fed well in front of the current situation, it would also make it more difficult for the Fed to manage expectations and by extension the fallout should those expectations be unfulfilled. 2) In early 2001 the 50bp rate cut was justified by a convergence of acute weakness in high frequency economic data, sharply lower stock prices and a real funds rate that was closer to 5%. Today, the economic data has yet to show a similar weakening in momentum; stock markets are still up on the year and real fed funds are restrictive at 3.3% but not like 2001.The Fed needs to show policy will remain fluid, as dictated by economic prospects and that can be achieved just as easily with 25bp as it can with 50bp. Moreover, Bernanke probably sees the longer term fundamentals as reasonably sound at this point given a global economy that remains solid and strengthening exports.

When the Fed does cut rates in September, expect the discount rate to be cut again as well. There are no guarantees that the Fed does cut rates, but Bernanke has demonstrated his mettle as an accomplished economist who is not about to let events get out of control. The Jackson Hole summit next week will give Bernanke an opportunity to talk to the markets (8/31). He will provide clear direction, in an attempt to solidify the calm that has thus far been exactly what he was trying to achieve with his actions of last week.

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