Don’t Expect Miracles

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Highlights

- The Federal Open Market Committee (FOMC) slashed the federal funds rate by 0.75% to 3.5%.
- The Fed left the door open to further rate cuts noting that "appreciable downside risks to growth remain" and that the FOMC "will act in a timely manner to address those risks."
- I now see the Fed cutting another 0.50% in March and 0.25% in June to bring the overnight lending rate down to 2.75% by mid-year.

In a surprise move, the Federal Open Market Committee (FOMC) slashed the federal funds rate by 0.75% to 3.5% today. The rate cut, which occurred one week ahead of the Fed's regularly scheduled January 30/31 meeting, was the largest since August 1982 when the Fed's benchmark interest rate stood at 12.5%. The action appears to be designed to let investors know that the central bank is on the case and will do everything in its power to avoid a US recession.

The Fed left the door open to further rate cuts noting that "appreciable downside risks to growth remain" and that the FOMC "will act in a timely manner to address those risks." St. Louis Fed President William Poole was the only committee member to vote against the move saying that he did not believe that current conditions justified policy action ahead of the Fed's regularly scheduled meeting next week.

The Fed's decision came on the heels of a sell-off in global financial markets on Monday which saw Asian stock markets down between 5% and 10% overnight. US financial markets sold off sharply at the open, but recovered some of their losses by early morning. By contrast, Treasury prices rose and yields declined with the 10-year yield falling to 3.55%. Fed officials will undoubtedly be watching investor reactions closely today in deciding whether or not to move again next week. However, the magnitude of the cut suggests that they would prefer to sit on the sidelines.

While we saw the risk of an intermeeting move given the fragility of the financial markets, we were surprised by the magnitude of the cut. Contrary to some, I have been impressed by the Fed's bold and innovative approach to monetary policy in this easing cycle. Whether it is today's 0.75% cut or the implementation of the Term Auction Facility (TAF) in December to address the problems in the interbank market. Although the timing of policy actions has not always been optimal, it is difficult to argue with any of the policy decisions. Unfortunately, the Fed is not a miracle worker and, as Fed Chairman Ben Bernanke is fond of saying, interest rate cuts impact the US economy with a long and variable lag.

Therefore, one should not expect the US economy to come bouncing back in the first or second quarters of 2008. Instead, the real adjustment will take time and will involve a further rise in the unemployment rate and larger declines in home prices to clear out excess inventories. This, along with the ongoing credit crunch and high energy prices, will act as a drag on consumer spending and will keep the risk of recession high in the first half of 2008. I would put the probability at around 60%. Consequently, I now see the Fed cutting another 0.50% in March and 0.25% in June to bring the overnight lending rate down to 2.75% by mid-year.

What does this mean for the financial markets? According to a recent study by Standard & Poor's, the S&P 500 stock index has declined an average of 26% peak to trough in the months leading up to the recession to the recession lows. The S&P 500 is currently down more than 16% from its highs. The good news is that after 10 of the last 11 recessions, stocks soared in the ensuing six months. On average, the S&P index gained more than 12%. Meanwhile, the pattern in the Treasury market has been for short-term interest rates to drop more than long-term interest rates and for the spread to increase. Right now, the spread between two-year and 10-year Treasury bonds is 1.4%. At the end of the last two cycles, this spread stood close to 2.5%.