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Preparing for a Fed Pause

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Highlights

- The Fed may begin preparing investors for a *pause* in its rate-cutting campaign, but it is unlikely to indicate that rate cuts have ended.
- The Fed wants to keep some of its powder dry so that it is not powerless to react when the deterioration in the real economy starts to feedback negatively on the financial markets later this year.

The Federal Reserve began its two-day April policy meeting this morning to discuss its next move in the unfolding credit crisis. Since last September, the central bank has slashed its benchmark federal funds rate by three percentage points to 2.25%. The Fed has also attempted to target liquidity to where it is needed most in the marketplace by employing less conventional policy tools, such as the Primary Dealer Credit Facility, which opened the Fed's discount window to non-bank broker-dealers for the first time since the Great Depression. These measures have had some success in improving the tone in financial markets, but credit conditions remain strained. Investors have responded by cautiously legging back into risky assets such as stocks and corporate bonds. The Standard & Poor's 500 stock index is up nearly 10% from the low it reached in early March.

It's Not Over, Until It's Over

Given this positive turn of events, I expect the Fed to slow the pace of interest rate cuts with a 25 basis point reduction in the fed funds rate to 2% at the conclusion of its policy meeting at 2:15pm EST tomorrow afternoon. I also expect the Fed to begin preparing investors for a *pause* in its rate-cutting campaign. This will provide the central bank with time to assess the impact of the fiscal and monetary stimulus that is already in the pipeline (the first set of tax rebate checks went out yesterday).

However, the Fed is unlikely to say that it is *finished* easing policy at this stage despite the fact that the fed funds futures have priced out any further interest rate cuts. The economic environment is still far too uncertain to claim victory at this point. Instead, the Fed is likely to maintain its *easing bias* for the time being noting that "downside risks to economic growth remain" in its policy statement. The Fed understandably wants to keep some of its powder dry so that it is not powerless to react when the deterioration in the real economy (employment, profits, production) starts to feedback negatively on the financial markets later this year.

Consequently, I am forecasting that the Fed will cut by another 50 basis points by the beginning of 2009 leaving the terminal fed funds rate at 1.5%. I continue to believe that we are in the early stages of a recession and historically the Fed has not stopped easing before a recession has officially ended. In fact, with the exception of the double-dip 1981-82 recession, the Fed has only finished cutting rates a year or more after a recession has ended. That said, the Fed will be reluctant to return rates to the 1%-level seen in the 2001 cycle given criticism the central bank received for leaving interest rates too low for too long and inflating the housing bubble.

It would not be unusual for the Fed to pause and resume easing. During the 2001 easing cycle, the Greenspan Fed paused for 11 months at 1.75% before eventually cutting its benchmark interest rate by another 50 basis points in November 2002 noting that the economy was working its way through a "soft spot". It then paused again for seven more months before its final 25 basis point cut which left the terminal fed funds rate at a generational low of 1% in June 2003. At that point, the Fed adopted a neutral policy bias noting that the "upside risks and downside risks to sustainable economic growth were roughly balanced".

Highlights

- If the Fed were to cut rates and then increase them shortly thereafter it would defeat the purpose of cutting them in the first place.
- Historically, the Fed has remained on hold for an average of 16 months after reaching the terminal fed funds rate.
- In the past, the S&P 500 stock index has posted an average total return of 15% once the fed funds rate has reached its nadir.

In all, three and a half years had passed from the time of the Fed's first pause to the time when the central bank eventually raised interest rates in June 2004.

Although increasingly popular, I disagree with the view that the Bernanke Fed will take back its interest rate cuts in short order to avoid repeating the mistakes of the past and inflating another asset bubble, this time in the commodity markets. Nor do I believe that the Fed thinks that there is an immediate risk that low interest rates will fuel a virulent inflation. Outside of food and energy prices, inflation readings remain benign and now that the unemployment rate has begun to rise, it seems unlikely that that higher commodity prices will translate into a wage-price spiral sparking a broader inflation as occurred in the 1970s.

It is my view that that once the Fed reaches its terminal fed funds rate it will be on hold for at least nine months to one year before it raises interest rates. The reasoning for this is simple: Interest rate cuts take nine months to a year to have their full impact on the US economy. If the Fed were to cut rates and then increase them shortly thereafter it would defeat the purpose of cutting them in the first place.

In addition, the financial deleveraging that is currently underway in the corporate and household sectors will be massively disinflationary requiring an extended period of low interest rates. Thus it is not surprising that historically once the Fed reached its terminal fed funds rate, it remained on hold for an average of 16 months before moving interest rates higher (see chart 1).

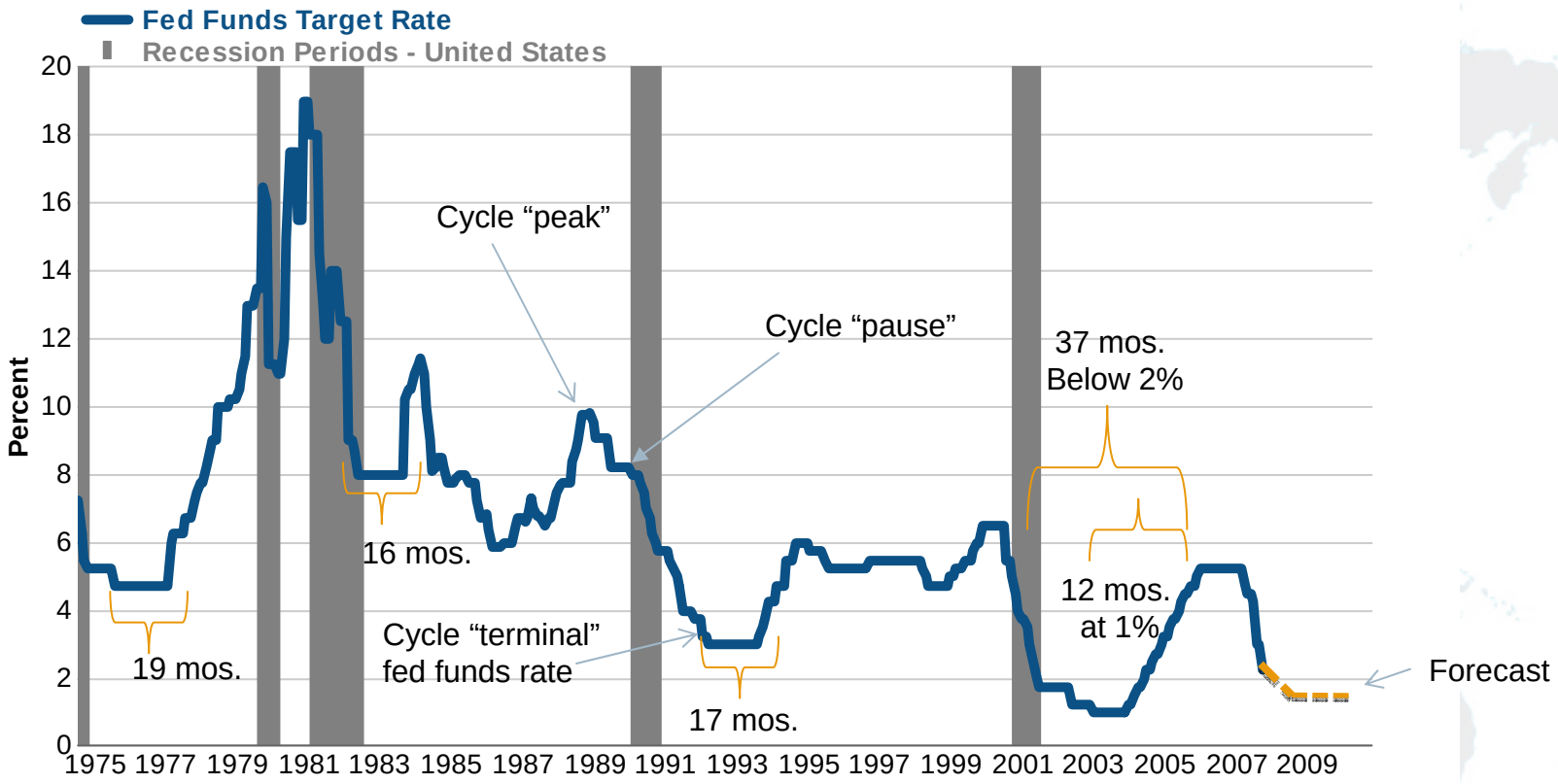
Risky Assets Should Do Better in the Coming Months

After a rough start to 2008, risky assets including stocks and corporate bonds have begun performing better in recent weeks as credit market conditions have improved. Looking back historically, we see that these asset classes have tended to perform well once the Fed has begun easing aggressively as it has in recent months. The S&P 500 stock index has posted an average total return of 15% and the spread between Moody's Baa and Aaa-rated bond yields has compressed by 63 basis points once the fed funds rate has reached its nadir (see chart 2).

Risk-free Treasury bonds, by contrast, have underperformed in these environments. That said, it is important to point out that Treasury yields have only tended to bottom once the Fed reached its terminal fed funds rate or sometime thereafter. Since I am forecasting another one or two rate cuts by the Fed after tomorrow, I still think we could see Treasury yields revisit their prior lows before the bond market rally has officially ended. Even so, the bulk of the rally is clearly behind us at this stage.

Chart 1: Fed *Pause* Could Last Longer Than the Market Expects

Federal Funds Target Rate



Source: Federal Reserve

1) In the past, the Fed has typically not stopped easing before the recession has ended
2) With the exception of the 1981-82 double-dip recession, the Fed has only stopped cutting rates a year or more after the recession is already over.
3) Average time on hold after an easing cycle is 14 months (range from 12 to 17 months)
4) The fed funds rate was held at or under 2% for 37 months from 2001 to 2004.

Chart 2: Risky Assets Do Well In Low Rate Environments

Performance When Fed Goes "On Hold"					
Fed Rate Bottoms	Months on Hold	S&P 500 Stock Index Total Return	Change in 2-Year Treasury Yield	Change in 10-Year Treasury Yield	Change in Moody's Baa to Aaa Credit Spread
January 1976	19	4%	-0.52%	-0.38%	-0.88%
November 1982	16	20%	1.03%	1.25%	-1.11%
September 1992	17	20%	0.32%	-0.71%	0.03%
June 2003	12	17%	1.22%	1.14%	-0.51%
Average	**16**	**15%**	**0.51%**	**0.32%**	**-0.62%**

At the conclusion of Fed rate-cutting campaigns in the past, stocks have risen by an average of 15% during the "on hold" period. Similarly, corporate bonds have performed well as credit spreads, which gauge their "riskiness", narrow. Risk-free Treasury bonds, however, have underperformed in these environments. That said, it is important to point out that Treasury yields have only tended to bottom once the Fed reached its terminal fed funds rate or sometime thereafter.