



Contact:

Thomas D. Higgins, PhD
Chief Economist

ph: 213 830-4302

email: thiggins@payden-rygel.com

Highlights

- Fed will act to limit the adverse effects of disruptions in the financial markets on the broader economy.
- Talk of moral hazard is misplaced since the Fed is reacting to developments in the real economy.
- A September rate cut is looking increasingly likely with investors pricing in an 80% probability that the Fed lowers rates.

Fed Stands Ready to Act

Today, Fed Chairman Ben Bernanke acknowledged that the problems in subprime have spread to other sectors of the financial markets and assured investors that the Fed “continues to monitor the situation and will act as needed to limit the adverse effects on the broader economy that may arise from the disruptions in financial markets.” Bernanke’s remarks came at an annual economic symposium hosted by the Federal Reserve Bank of Kansas City in Jackson Hole, Wyoming.

The Fed Chairman dismissed the idea that the central bank would bail out lenders or investors. However, he noted that “developments in financial markets can have broad economic effects felt by many outside the markets, and the Federal Reserve must take those effects into account when determining policy.” Bernanke went on to say that if current conditions persist in mortgage markets, the demand for homes could weaken further, with possible implications for the broader economy. To put it plainly, the Fed is well aware that what happens on Wall Street can impact those on Main Street. Thus, all the talk of moral hazard and the reinstatement of the Greenspan Put are misplaced since the Fed is reacting to the impact of financial market turbulence on the real economy.

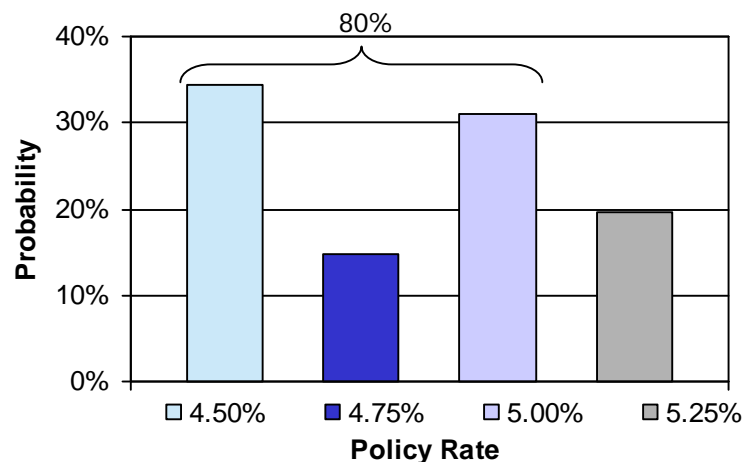
Pay Close Attention to High Frequency Indicators

Bernanke also said that recent financial developments imply that “economic data bearing on past months or quarters may be less useful than usual for our forecasts of economic activity and inflation.” In other words, the upward revision to second quarter GDP to an annual rate of 4% announced earlier this week is largely irrelevant. Instead, the Fed will focus on more timely indicators, as well as information gleaned from our business and banking contacts around the country. Thus, investors should be watching high frequency data such as unemployment claims and mortgage applications as well as the Fed’s Beige Book and the ISM purchasing manager’s surveys in the coming weeks. The recent uptrend in unemployment claims has almost certainly caught the Fed Chairman’s eye.

What Next?

In the past two weeks, the Fed has injected nearly \$60 billion into the overnight lending market and reduced discount rate by 50 basis points to 5.75%. Although the central bank has stopped short of cutting the benchmark federal funds rate, such a move is looking increasingly likely. The fed funds futures market is currently pricing in an 80% chance of a cut at the Fed’s September 18 meeting.

The Federal Funds Futures



Source: Bloomberg