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Tough Love From The Fed

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Highlights

- The Federal Reserve left its benchmark interest rate unchanged at 2% today, much to the chagrin of investors in the futures market who had priced in an 80% probability of a cut.
- I agree with the Fed's decision to leave rates unchanged today because I don't believe rate cuts are the appropriate medicine for what ails the US economy at this point.
- Fed rate cuts have been ineffective in bringing down mortgage rates and getting cheap money to where it is needed most –in the pockets of would-be new home buyers.

The Federal Reserve left its benchmark interest rate unchanged at 2% today, much to the chagrin of investors in the futures market who had priced in an 80% probability of a cut. The central bank also maintained a neutral risk assessment noting that "the downside risks to growth and the upside risks to inflation are both of significant concern."

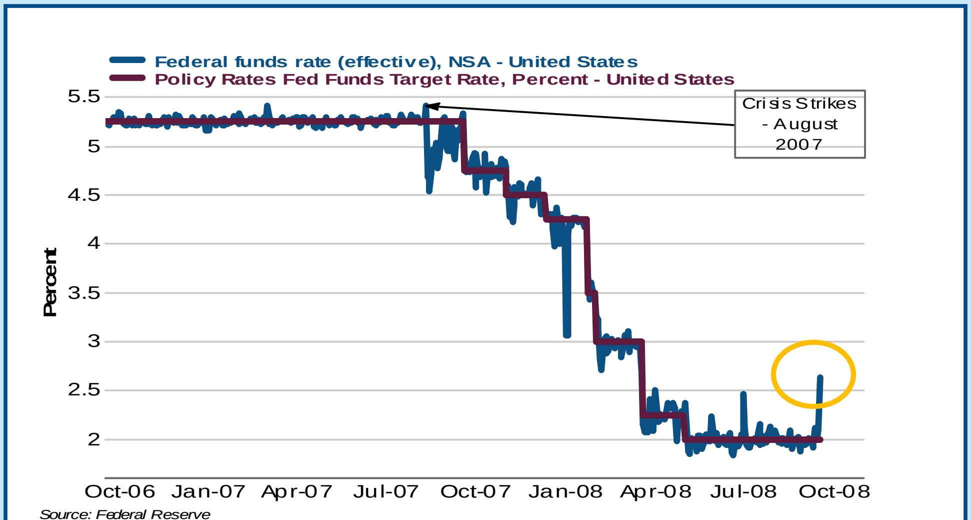
Though investors didn't get the rate cut they wanted, policymakers did throw them a bone or two. The Fed injected $70 billion in funds into the overnight market since yesterday to insure proper functioning of the capital markets as banks become more skittish about lending to one another in the aftermath of the Chapter 11 filing by Lehman Brothers on Monday (see chart below). The Fed also lent Lehman $138 billion to clear and settle outstanding trades and provided a support package for American International Group (AIG), which has run into troubles due to its investments in the subprime mortgage market. These measures, along with declining oil prices and better than expected earnings from Morgan Stanley and Goldman Sachs, led to a late bounce on Wall Street. The Standard & Poor's 500 stock price index rose 1.8% to close at 1,214 today.

Getting Money to Where It Is Needed Most

I agree with the Fed's decision to leave rates unchanged today, not because I believe the risks to economic growth and inflation are balanced, but rather because I don't believe rate cuts are the appropriate medicine for the US economy at this point. The Fed has taken drastic actions to restore proper functioning to financial markets including slashing the fed funds rate by 325 basis points to 2% and boosting liquidity through the primary dealers credit facility (PDCF) and the term security lending (TSLF) facility. The problem is that these measures have largely failed to bring down mortgage rates and get cheap money to where it is needed most –in the pockets of would-be new home buyers. Prior to last week, the rate on a 30-year fixed rate conforming mortgage was actually up slightly from year ago levels.

Since that time the US Treasury has announced that it is going to purchase mortgages from mortgage giants Fannie Mae and Freddie Mac and rates on conforming loans ($417,000 or lower for most markets) have tumbled 70 basis points to 5.83%. The Treasury's decision to buy Fannie and Freddie mortgages will hopefully lead to a peak in interest rates in the market for conforming loans and encourage investors in these securities to jump in and buy before rates drop any further.

Dislocations in the Market for Overnight Funds Remain a Problem



Source: Federal Reserve

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- It is important for policy makers to let nature take its course, which implies that investors will experience some pain and some large firms will cease to exist.
- Unfortunately, the unwinding of leverage associated with these failures will keep a lid on economic growth and will restrain activity even as the US economy enters its recovery phase in the second half of next year.
- Further interest rate cuts are possible given the risks to the US outlook and the potential for a negative feedback loop between financial markets and the real economy.

Before we can dig our way out of the credit crisis, it will be necessary to stabilize the housing market, and more specifically house prices. Only then will we stop the hemorrhaging in the mortgage backed securities (MBS) market which is at the root of the problems in the broader credit markets. Lower mortgage rates along with declining home prices are increasing the affordability of housing and will eventually encourage new home buyers to dip a toe into the market. In the longer-term, risk appetite will eventually return and this should benefit the credit markets, though this is unlikely to occur overnight. In the meantime, most of the borrowing and lending that occurs in the US economy will be done through the traditional banking system.

Culling the Herd

The failure of Lehman Brothers Holdings and the troubles at AIG have sent shockwaves across financial markets in recent days. It seems to me that the more “hands off” approach that has been taken by both the Fed and the US Treasury in allowing Lehman to fail is appropriate at this stage of the credit crisis. It is important for policy makers to let nature take its course, which implies that investors will experience some pain and some large firms will cease to exist. Once this process is complete, it will pave the way for a new economic expansion.

The culling of the herd on Wall Street is a painful process, but it is not unusual following economic booms in a properly functioning capitalist system. In the late 1980s and early 1990s, more than 1,500 savings and loan institutions went belly up following the collapse of the commercial real estate market. Then in 2001, the bursting of the technology bubble brought unprofitable IT firms to their knees. In each of these instances, the firms who survived were left with more profitable opportunities as their less talented counterparts were allowed to fail.

Today, it’s the residential real estate market that is wreaking havoc on the investment banking industry. During the final years of the 2002-2007 economic boom, the financial field was getting overcrowded at a time when technological advances and increased transparency were reducing returns. This led financial firms to take on excessive amounts of leverage to invest in low quality, low yielding assets. Those who stayed at the party too long are bearing the brunt of the pain associated with the unwinding of this leverage. In time, the bloodshed on Wall Street will end as part of a natural process when short sellers – those who bet the price of a firm’s stock will fall – come up against a member of the herd who turns out to be healthier than they expected.

Unfortunately, the unwinding of leverage associated with these failures will keep a lid on economic growth and will restrain economic activity even as the US economy enters its recovery phase, which I believe will occur in the second half of next year. In the interim, further interest rate cuts are possible given the risks to the US outlook and the potential for a negative feedback loop between financial markets and the real economy. However, the Fed is less likely to respond to financial market disruptions with rate cuts given the flack it received for doing so earlier this year and the fact that rate cuts are ineffective for curing what ails the markets at the current time.