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Market *Flash*

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FEDERAL RESERVE CONTINUES TO FOCUS MONETARY POLICY ON PLACATING FINANCIAL MARKETS

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On January 30, the Federal Reserve gave financial markets what they demanded by cutting the federal funds target rate by another 50 basis points to 3% (the lowest level since June 2005) and leaving the strong easing bias in the policy statement unchanged. Today's action brings the cumulative policy easing to 125 basis points in the past two weeks and 225 basis points since the crisis began in August.

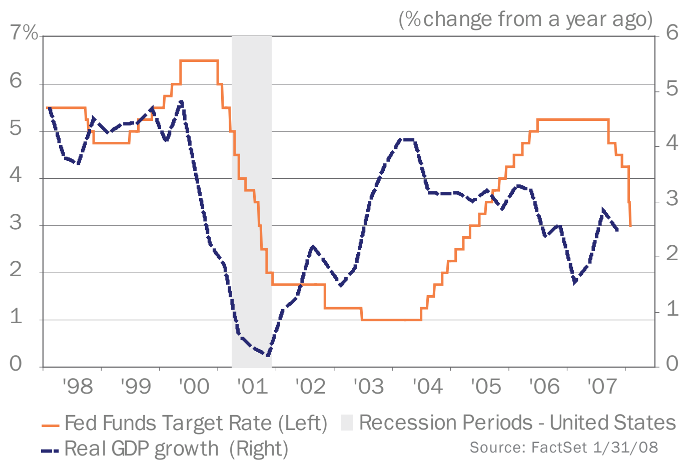
The move was widely expected. Futures markets had priced in about a 93% chance of a half-point cut, although economists surveyed by Bloomberg were somewhat less bullish. However, 57% were looking for at least a 50 basis points move (including ourselves).

Financial market reaction proved disappointing, however. The S&P 500 was trading down about 0.3% that day prior to the decision and shot up to a 1.7% gain immediately afterwards, but pared those losses again on negative corporate news in the afternoon. Similar to the previous week's action, a major rate cut failed to lift stocks.

Here are the highlights of the Fed's policy statement that were issued together with the rate decision:

- The main focus remains on financial markets: "Financial markets remain under considerable stress, and credit has tightened further for some businesses and households," which is similar to the January 22 statement. Looking at the evidence, credit spreads have indeed widened further, but inter-bank rates have moderated, suggesting that liquidity conditions in that sector are improving as a result of lower policy rates and substantial liquidity injections.
- On the economy: "[..] recent information indicates a deepening of the housing contraction, as well as some softening in labor markets," again very similar to the January 22 statement. Housing data did indeed deteriorate, as seen in recent sales, price and GDP data, but the softening in labor markets is still the old December view, which is likely to change after today's jobs report. The latter is now expected to show a stronger rebound in job growth and probably a small decline in the unemployment rate.
- On inflation: probably the biggest and most important change in the past two weeks. As recent as the December 11 FOMC meeting, the Fed still highlighted residual inflation risks. "[..] the Committee judges that some inflation risks remain, and it will continue to monitor inflation developments carefully." Since that time, core CPI has accelerated from 2.1% in October (the last available data point at the December 11 FOMC meeting) to 2.4% in December. Still, in the January 22 statement (unchanged in today's release), the Fed turned inflation concern on its head and now "expects inflation to moderate in the coming quarters." With that call, the Fed raises the stakes for monetary policy in the future. If inflation continues to drift higher in the coming months, the central bank will face considerable pressure to raise rates to bring about the moderation it is now forecasting.
- Forward-looking risk bias: The statement downgraded the growth risk assessment stating "downside risks to growth remain" a slight improvement from "appreciable downside risks" on January 22. Nevertheless, the focus remains firmly on growth, as opposed to the more balanced stance that prevailed through most of last year.
- Forward-looking policy bias: The statement left the key forward-looking part unchanged. "The Committee will continue to assess the effects of financial and other developments on economic prospects and will act in a timely manner as needed to address those risks." The phrase "timely manner" suggests the possibility of another inter-meeting rate cut, if financial market conditions continue to deteriorate. Keep in mind that the next meeting is nine weeks away.
- Like the January 22 meeting, today's decision was not unanimous. Dallas Fed President Richard Fisher voted for no change in the funds rate. Since this was the first scheduled meeting in 2008, the FOMC composition changed from last week when St. Louis Fed President Poole (not a voting member in today's meeting) voted against a cut.

U.S. – Real GDP vs. Target Federal Funds Rate



Clearly, the Fed remains in extreme risk-management mode. After last week's 75 basis points rate cut, which was triggered not by any new developments in the real economy, but fears of a general stock market meltdown (probably amplified by the actions of a rogue trader at French bank Societe Generale), the Fed kept placating financial markets with another 50 basis points in rate cuts, despite growing evidence that the economy did not slip into a recession at the turn of the year.

In our opinion, the Fed has embarked on a risky policy experiment, abandoning any real economic anchors to its monetary policy decisions (which usually address inflation or economic growth) and has instead focused entirely on a low-probability/high-impact outcome – of a potential credit crunch as a result of impaired bank balance sheets. We believe the current strategy is greatly increasing the risk of reinflating the bubbles that led to the current predicament and could lead to a faster acceleration in inflation, which already started to trend higher in the past three months.

We also think the Fed is now paying the price for a lack of "market presence" in the past six months. The key problem is not a lack of growth in the economy, but a loss of confidence in the functioning of the U.S. financial system. What we need is time for banks and brokers to repair their balance sheets and resume their credit-intermediation role. There is enough supply of credit, provided in part by extraordinary liquidity injection by the Federal Reserve and abundant global capital reserves, and there is enough demand for credit among corporations and households. What has been damaged is the transmission process that brings supply and demand together.

Where do we go from here? It has become increasingly difficult to forecast future Fed moves. The risk of a more serious credit crunch will not go away for awhile, and stock markets will remain extremely volatile. In the past few months, financial markets tended to sell on rumor and ignore the facts.

Treasuries already priced in a significant probability of recession at the end of last year, and stocks have caught up in the past few weeks, while the evidence from the real economy remains mixed at best. Despite a much-lower-than-expected 0.6% growth rate, fourth quarter GDP growth was inconsistent with a slide towards recession. Moreover, recent data on consumer confidence and job growth points to an improvement in economic activity in January.

The Fed's current strategy of fast, decisive rate cuts suggests a significant probability of another inter-meeting cut, if financial market trends deteriorate again in the (almost infinitely long) nine-week period until the next regular FOMC meeting on March 18. What could calm fears would be more convincing evidence that the economy is rebounding, but even we are not forecasting that in the next few months. In fact, after stronger data in January, February activity could be negatively impacted by extreme weather conditions in the U.S., which would keep the bear camp calling for a recession and stock markets in selling mode.

Looking further down the road, the Fed's reputation will depend on the inflation trajectory in the coming months. We continue to believe the economy won't slip into a recession, partly as a result of the strong policy and regulatory response we have seen in recent weeks. If that is the case, then lower rates, a strong fiscal stimulus, and a new refinancing wave – in addition to high energy cost and rising import prices (as result of the weak dollar) – could push inflation higher over the summer. Such a development would put pressure on the Fed to quickly reverse course and rescind some of the emergency rate cuts before the year is over.

Bottom Line: It will be increasingly "costly" for the Fed to disappoint markets without abandoning its very strategy of maintaining financial market stability. In that environment, further substantial, out-of-schedule rate cuts are likely, yet difficult to forecast. For now, we expect only one more 25 basis points rate cut on March 18, consistent with our economic forecast of 2% growth in each of the first two quarters of 2008 and a more significant rebound in the second half. However, it is difficult to have confidence in our Fed call, given the lack of real macro arguments to support such a forecast. ■