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Monday Morning Outlook

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Rate Cuts Would Increase Recession Risk

Problems in the sub-prime loan market have spread, affecting financial institutions worldwide. The latest was BNP Paribas, France's largest bank, which halted withdrawals from three investment funds.

At this point, no one knows for sure how many mortgage defaults will actually occur, and it will be years before the total damage from defaults on risky mortgages can be fully assessed. This uncertainty has caused the securitized mortgage market to seize up, sending risky bond prices down sharply. Leverage magnifies the pain. Some hedge funds have been forced to liquidate, but the full extent of the financial pain is unknown. While the real economy is, and should, remain strong, confidence has been shaken.

Late last week worried banks pulled back from lending to each other, driving the federal funds rate to 6% early on Friday morning, well above the Fed's target rate. To get the inter-bank lending rate back down to 5.25%, and keep it there, the Fed temporarily added $38 billion to the banking system on Friday (after $24 billion on Thursday), the most since September 2001.

To add some perspective, up to last week, the Fed's average daily injection of liquidity so far this year was $9 billion. It added a total of $35.5 billion on December 20 and 21, 2006 for Christmas spending and during the week after September 11, 2001, the Fed averaged $75 billion per day. In other words, the Fed's actions are aggressive but not extraordinary.

Nonetheless, the federal funds futures markets have priced in rate cuts starting soon. We disagree – we do not think the Fed will cut rates. First, a rate cut of 25 or 50 basis points is not going to help homeowners stressed by exotic mortgages with steep rate re-sets. Second, a rate cut may actually increase the odds of recession.

Rate cuts would ratify financial market expectations of a bailout; the same reason firms were willing to get over-leveraged and over-invested in housing in the first place. In turn, this would encourage further misallocations of credit.

Rate cuts would also boost inflation from already higher than comfortable levels – forcing the Fed to tighten more aggressively in 2008, possibly causing a recession.

This is not just economic theory; it's what happened in 1987. After he was appointed Fed Chairman in August 1987, Alan Greenspan faced an inflation rate of roughly 4%. To fight inflation, he lifted the funds rate from 6.63% to 7.31%. Then, on October 19, 1987, the stock market dropped 22.6% in one day. The Fed was forced to cut rates even though monetary policy was not tight and inflation was still on the rise. The funds rate fell to 6.5%, which offset all of the previous Greenspan hikes, plus a little more.

Once it became clear the market correction had not led to a recession (despite widely held fears), the Fed had to start its work against inflation from scratch and was even further behind the curve. The funds rate eventually hit 9.8% in May 1989, and the "real" (inflation-adjusted) federal funds rate rose to 5.3% (using "core" CPI for inflation) - the highest since the early 1980s, and a level never reached since. This tight money was a principal cause of the 1990/91 recession.

The lesson: loose money may help calm market fears, but a day of reckoning eventually comes.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
8-13 / 7:30 am	Retail Sales – Jul	+0.2%	**+0.2%**	***+0.3%***	-0.9%
7:30 am	"Core" Retail Sales - Jul	+0.3%	**+0.2%**	***+0.4%***	-0.4%
8-14 / 7:30 am	Int'l Trade Balance - Jun	-$61.0 Bil	**-$60.6 Bil**		-$60.0 Bil
7:30 am	PPI – Jul	+0.2%	**+0.3%**		-0.2%
7:30 am	"Core" PPI – Jul	+0.1%	**+0.1%**		+0.3%
8-15 / 7:30 am	CPI – Jul	+0.2%	**+0.2%**		+0.2%
7:30 am	"Core" CPI – Jul	+0.2%	**+0.2%**		+0.2%
8:15 am	Industrial Production - Jul	+0.3%	**+0.2%**		+0.5%
8:15 am	Capacity Utilization - Jul	81.8%	**81.7%**		81.7%
8-16 / 7:30 am	Initial Claims - Aug 11	312K	**310K**		316K
7:30 am	Housing Starts - Jul	1.410 Mil	**1.423 Mil**		1.467 Mil
11:00 am	Philly Fed Survey - Aug	8.4	**10.3**		9.2