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FIRST Trust ADVISORS L.P.

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Economic Commentary

They Actually Did It – Cut Rates That Is

Well, they actually did it. The Federal Reserve, and Chairman Bernanke, cut the federal funds rate and the discount rate by 50 bps. The Fed argued that their action was meant to "help forestall some of the adverse effects [from tightening credit conditions] on the broader economy."

The stock market loved it with the Dow up more than 400 points over two days, and the NASDAQ up more than 80 points. The pundits loved it, too. But cash gold prices have now moved above $730/oz. If prices stay at this level for a month, gold will set a new monthly all-time record high.

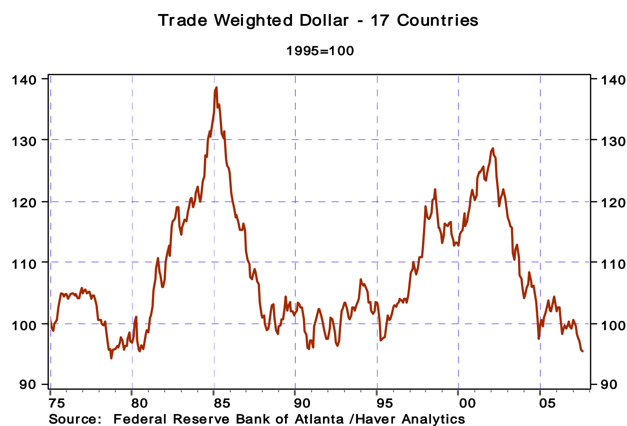
Oil prices jumped to an all-time high, of $82/bbl., and the dollar tanked, losing more than 1% of its value versus foreign currencies. To top it off, the price of the 30-year Treasury bond has fallen by more than three full points, pushing the yield to 4.92%, which raises the cost of fixed rate mortgages.

The rise in stocks was probably welcome by the Fed, but we can't imagine the Fed wanted to see inflation sensitive markets behave this way. The Fed's number one responsibility is to protect the purchasing power of the dollar. But this is not happening.

A Misunderstanding of the Problem

Some analysts thought a Fed rate cut would push the dollar up and gold down. They argued the Fed was so tight that markets were being squeezed, and this was causing demand for the dollar to fall. They also argued that if the Fed cut rates, and supplied new money, the markets would unlock, demand for the dollar would rise, gold prices would fall and the dollar would rise. Oops!

The idea that the Fed is too tight is based on a few different arguments. First, that trouble in commercial paper markets does not occur unless liquidity is scarce. Second that housing is a leading indicator of Fed tightness. And finally, that real GDP grew just 2% in the past year.



But none of this is proof of tight money. Every single problem in the economy and credit markets emanates from housing. And the housing market is clearly suffering because interest rates were too low between 2001 and 2004, which led to absurdly loose credit standards. So loose, that even Alan Greenspan could not imagine how much lending standards had deteriorated. In some ways we can't blame him. Who could imagine mortgages were being made to people with no money down and no proof of income? And who could imagine those loans were bought by the smartest people in the room at major hedge funds?

But they did. And the reason this house of cards is falling down is because interest rates did not stay absurdly low. But that does not mean interest rates are too high or that the Fed is too tight. In fact, interest rates today are significantly below the levels of the late 1990s when things were so good it was called a bubble – a false boom. Today's problems exist because interest rates *were* too low, not because they *are* too high.

It is the excesses of the past that are causing problems in the asset backed commercial paper market, not tight money, and ditto for the housing market. In addition, non-housing real GDP grew at a 3.1% annual rate in the first half of the year. No evidence of tight money there.

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Pushing on a String

To understand why the Fed's policy stance is inflationary, it is important to understand monetary policy. And the first thing to understand is that the Fed does not control interest rates directly. It controls the money supply. By injecting more money in the system, the Fed drives interest rates lower. If the Fed withdraws money, or slows its growth, it pushes interest rates up.

Despite this truth, most people mistakenly view Fed policy through the lens of interest rates and believe lower interest rates are a catalyst for increased economic activity and greater profits. But this is only a short-term phenomenon. If the Fed is holding interest rates below their "neutral rate," it must inject more money than the economy actually needs. This creates inflation.

That's what commodity prices (including gold and oil) and the weakening dollar, are telling us – the Fed is adding more liquidity than the economy really needs. This is the danger of trying to fight off credit market problems with easy money. Lower interest rates can make things appear profitable when they are not. Eventually, the piper must be paid and that will come in the form of losses to investors and higher interest rates in the future.

The End Game

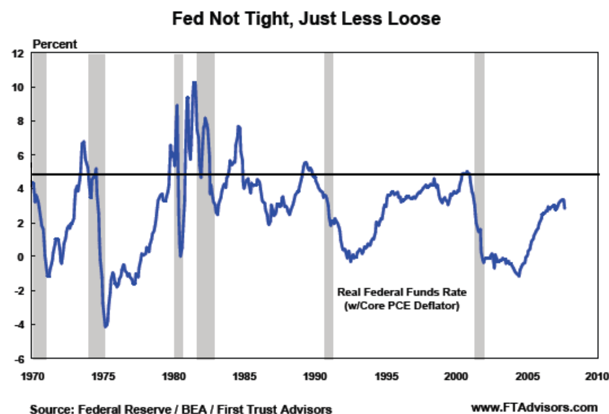
The Fed is most likely aware of all these risks and took them willingly because it is involved in a risk management project. The Fed believes risks to the economy are greater than the risks from inflation. It also believes any extra inflation that results from Tuesday's rate cuts can be offset at some future date.

The problem with this thinking is that the Fed cut rates before inflationary pressures had actually receded. When Alan Greenspan cut rates (and the Greenspan Put was born) dis-inflation was the story. This meant that the Fed could risk easy money for a while without creating a situation it could not control.

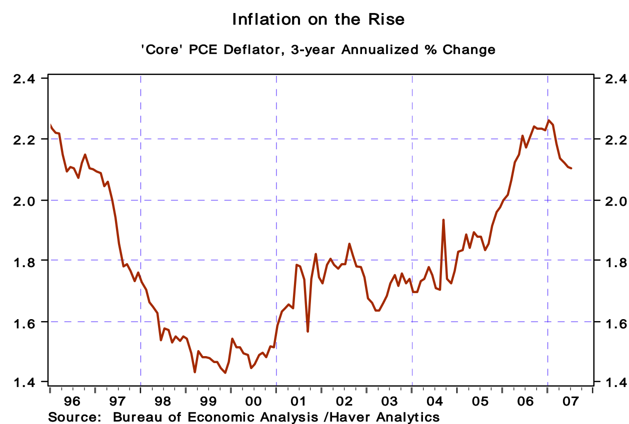
This time, inflation is still in an upward trend. Moreover, this is the lowest real federal funds in over 40 years at which the Fed reversed course and started cutting interest rates (see chart). In other words, the Fed cut rates this time before it ever got tight, unlike 2000 or 1989.

In its statement describing why it moved, the Fed tipped its hat toward these risks, acknowledging "some inflation risks remain." But obviously it was willing to ignore this risk for the time being because it foresees problems with the economy that are not visible with the naked eye.

The Fed cut rates with the stock market still up on the year, real GDP growth averaging around 3.5% between March and September, very low initial unemployment claims, and some clear improvement in commercial paper markets.



If the Fed can cut interest rates in this environment, when it still sees risks of inflation, then no one can argue that it won't cut again. As a result, even though the economy and equities markets will respond positively to the easy money in the next six to nine months, inflation risks will remain.



That said, further rate cuts are unlikely if economic activity remains robust. And that appears highly probable. The housing market is only 5% of the economy, liquidity is plentiful and free capital markets are perfectly able to absorb losses. As a result, it is highly likely that in 2008 the Fed will be forced to reverse its rate cut and push rates above 5.25%. At that point, just like after the rate cuts in 1987 and 1998, the economy will face its greatest risks.

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