

Economics

Fed Downshifting

John Ryding (212) 272-4221 / jryding@bear.com

Conrad DeQuadros (212) 272-4026 / cdequadros@bear.com

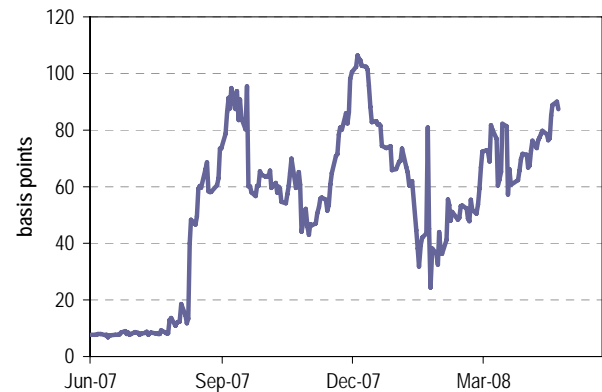
Meghna Mittal (212) 272-1961 / mamittal@bear.com

Next week's FOMC meeting is likely to mark a significant downshifting in the pace of interest rate reduction. In opening the discount window to the nonbank primary dealers, the Fed has massively reduced the systemic risk of a financial meltdown. However, it is also clear that funding pressures remain and the need of financial institutions to raise capital is in the headlines every day. Fed liquidity shots do not provide capital—although a steep yield curve enables financial institutions to earn capital by exploiting carry over time—and it appears that the bodies of bad positions are still coming to the surface (witness today's news about the \$24 billion capital raise by a large UK financial institution). On the economy, as we have continued to argue, the U.S. appears to have slipped into recession, which is likely to keep the Fed wanting to lean further against growth headwinds with monetary ease.

However, the inflation story continues to deteriorate and, with oil almost at \$120 per barrel, the Fed's hope that falling oil prices will ease inflation pressures looks something of a remote one at the present time. In short, fears of inflation are likely to limit the Fed's generosity on the rate front and we only expect a quarter-point cut on April 30th to put the fed funds rate target at 2%.

Monetary Policy Can Only Do So Much ... And at a Cost

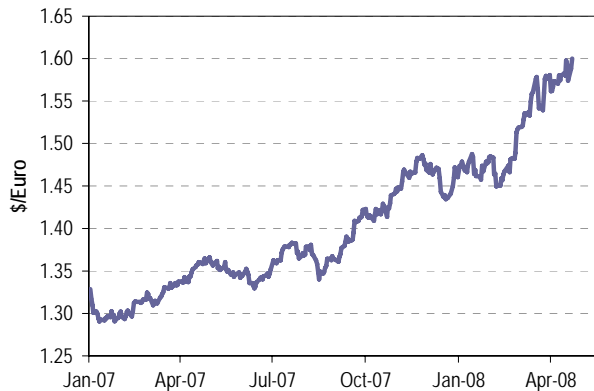
We have argued that monetary policy can only do so much to stabilize the real economy at the present time. The pressure on the economy has come not from tight monetary policy but from the collapse in housing and the collateral impact that this had on the structured credit markets and the capital adequacy of the financial system. Easier monetary policy does nothing to restore faith in the ratings agencies or to inject capital into the bond insurers or into financial institutions (except over time via the carry trade). It is the case that lower rates will alleviate the pressure from resets on adjustable-rate mortgages. However, interest rate resets have only been a bit player thus far in the mortgage-market debacle, which has primarily been the product of extremely lax mortgage underwriting standards coming home to roost as a result of lower house prices. Moreover, lower interest rates reduce the incomes of households that rely on interest income from floating rate assets. The other side of the interest rate carry trade is a massive reduction in interest income on the \$7.4 trillion deposit base owned by U.S. households. Furthermore, the Fed is well aware that monetary policy works with a lag and the 175 basis points of interest-rate reduction over the last three months will have had no discernible effect on economic activity at this point. The Fed, therefore, is likely to want to go slowly in lowering rates from here to avoid over-easing.

Figure 1: Overnight Index Swap Spread

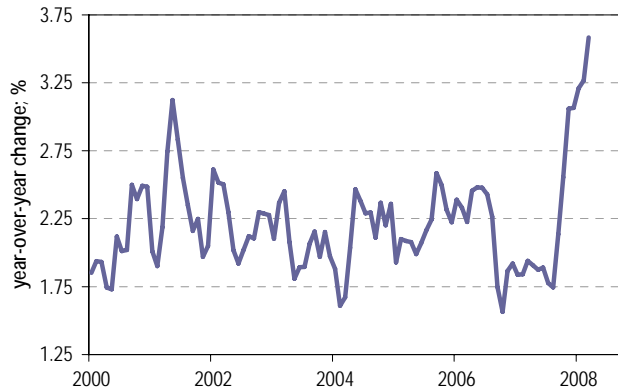
Source: Bloomberg

The cost of easier policy is, in our judgment, becoming more apparent in terms of inflation pressures and the value of the dollar. For example, the euro has now risen to \$1.60/euro, which is a record low for the dollar. However, while the dollar is falling against the euro, the central bankers at the ECB are emphasizing inflation risks over growth risks. In March, the consumer inflation rate in the eurozone hit a record high of 3.6% and the ECB is talking up the need to address inflation risks. The Bank of France's Christian Noyer, who is something of a centrist, said today "Our big problem is to ensure that inflation comes back below 2% next year ... if necessary, we will adjust interest rates." These sentiments were echoed by Greece's Nicholas Garganas, who today said that "Risks to price stability have increased ... Markets have expected interest-rate cuts for months, but under these conditions, for reasons that have been well explained by Mr. Trichet, interest rates couldn't fall."

The foreign exchange value of the dollar is, in some sense, a reflection of the relative confidence in the monetary policies of the Fed and the ECB, and the dollar is falling victim to U.S. easing. One of our three macro-strategy themes at the beginning of the year was to be short the dollar (the other two were U.S. yield curve steepeners and U.S. inflation protection) and, at this point, we not seeing or hearing anything that would lead us to exit this theme at this point. Moreover, to us, it is simple economic logic that if inflation problems are rising in Europe and if the dollar is falling versus the euro, then inflation pressures are rising more quickly in the U.S.

Figure 2: Dollar-Euro Exchange Rate

Source: Federal Reserve Board

Figure 3: Eurozone Consumer Price Inflation

Source: Statistical Office of the European Communities

Markets' Denial

What is somewhat at odds with our views on the U.S. economic outlook is the relative resiliency of the U.S. equity market and the modest recent tightening in credit spreads. One interpretation is that we are too pessimistic in our views on the economy and that the recession is likely to be shorter than we anticipate or that the rebound in growth in 2009 is likely to be sharper than we are forecasting. This is possible but, in our view, credit is the lifeblood of the economy and the problems in the banking and financial system remain very significant. Our best guess is that the tightening in spreads represents a relief rally as the Fed removed the risk of a financial system implosion and that spreads will grindingly widen as the reality of the current economic and financial environment sink in. At best, we expect real GDP to be little more than flat in 2008 and to grow at 2.0% in 2009 as financial companies remain cautious on lending and continue to repair their balance sheets and restore more adequate capital ratios.

As for the Fed, we expect that after next week's FOMC meeting, there will be one more cut that will take the fed funds target rate down to 1¾%. At the present time, fed funds futures are not only deeming such a cut unlikely but are pricing in a significant chance of a rate hike in the second half of the year (the implied January 2009 fed funds rate based on futures is 2.21%). We are willing to concede that 2% could be the terminal fed funds target rate but we think it is very unlikely that the Fed will hike rates until it is clear that the recession has come to an end and that the financial system is on a more solid footing. The Fed has never hiked rates in the wake of a recession until the unemployment rate has peaked and we do not see unemployment peaking until the middle of 2009. We expect, therefore, that the market will price out the second half rate hike as the economic data unfold and that the U.S. Treasury curve will re steepen somewhat in the second half of the year.