Tea Leaf

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Your guide to understanding today's economy and financial markets

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Fed Clatter

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Financial market players around the globe were largely pleased to see the Federal Reserve reduce its antiquated and rust-covered discount rate on Friday, August 17 from the prior rate of 6.25% to 5.75%. The discount rate is that borrowing rate where financial institutions in need of "emergency" funding can pledge various types of securities and loans as collateral to offset new borrowings.

The Fed also took the unusual step of allowing such borrowing for 30-day increments, with an option to renew the loan, as opposed to the traditional overnight advance. In reality, such moves had much more to do with emotional support than actual financial impact.

Discount window borrowing has been almost microscopic in recent years for two primary reasons. The first reason is that financial institutions could typically borrow vast amounts at the federal funds rate, which has usually been 1.0% lower than the discount rate in recent years.

The second reason is that the Fed, or financial market players, or some combination of the two, has conveyed the idea that a financial institution would borrow from the discount window ONLY if more attractive sources of funding were exhausted or denied, and ONLY if in a state of emergency. Total discount window borrowing averaged $6 million weekly in the two weeks prior to the Fed's cut.

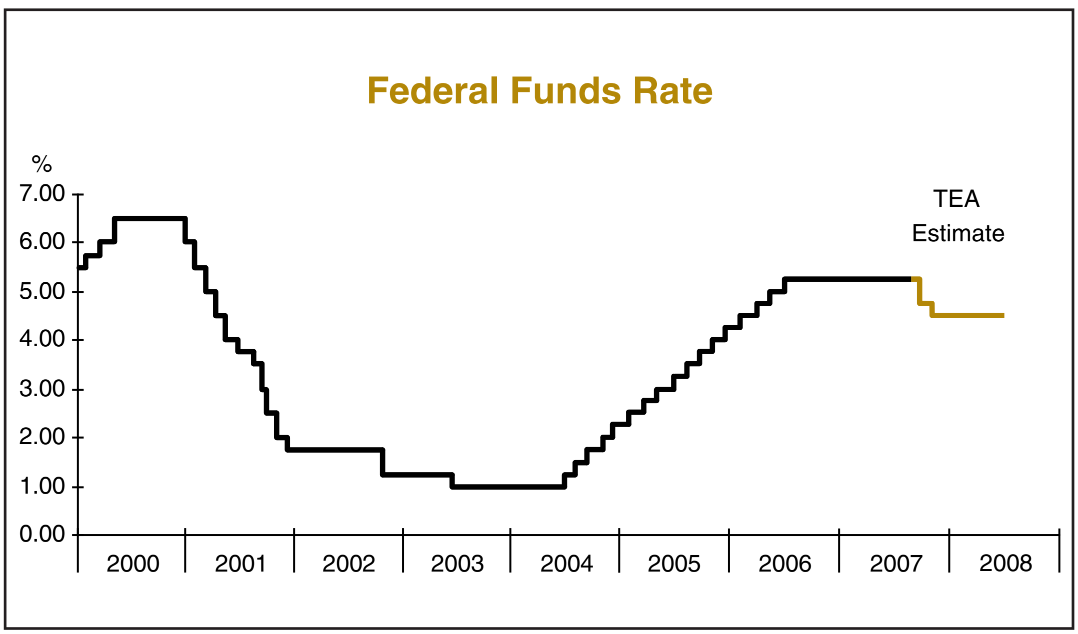
Such a total is almost inconsequential in a financial market where tens of billions of dollars are traded daily. The Fed took the unusual step of inviting banks to borrow at the window, and noted that the Fed would look on such borrowing as a sign of strength, not weakness…

…yea, right

In my mind, borrowing at the discount window has always been similar to when younger adults might have to contact Mom and Dad for a loan. The folks might be there for you, but you feel like crap (and yes, I have been there).

The Old Days

In the Fed's olden days prior to passage of the Monetary Control Act of 1980, the Fed routinely raised or lowered the discount rate as the primary means of impacting monetary policy. Also in those days of yore, the Fed would increase or decrease reserve requirements on select deposits as a means of reducing or expanding the amount of money available to lend by commercial banks.



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Such moves with either the discount rate or reserve requirements have been largely moot during the past 27 years. Why? Fed money tinkerers found that manipulation of the federal funds rate—the rate at which financial institutions sell surplus funds to other financial institutions on an unsecured overnight basis—was a much more desirable monetary tool.

So it was with a bit of market disbelief that the Fed reduced its discount rate by one-half percent. What the Fed accomplished was to show extremely anxious, gun-shy, and panic stricken global financial markets that the institution was ready to prevent a larger credit meltdown.

Market Impact

Some market players described the Fed move as "brilliant"…a way of demonstrating financial market support, while at the same time leaving its most critical and effective powder…a cut in the important federal funds rate…dry. Others were less impressed, suggesting that the Fed must deliver more.

Stock prices rebounded nicely on Friday, with a rise of more than 230 points in the Dow average. Market performance was uneventful on Monday and Tuesday, with a 30-point loss on Tuesday offsetting a 42-point advance on Monday. Stocks rose impressively on Wednesday morning.

Unfortunately, global financial markets remain largely fixated in abundant fear, with many global investors totally shunning certain extremely short-term investments that were largely viewed as risk free just a few weeks ago. Players in this commercial paper market are totally shocked at current investor abhorrence of non-government guaranteed debt instruments.

Tough Position

The Federal Reserve finds itself in an undesirable and unwanted position…

More and more financial market participants want to see the Fed step up and cut its federal funds rate…and sooner rather than later. The Fed's Open Market Committee (FOMC), the group within the Federal Reserve that determines monetary policy, next meets on September 18.

Most market participants fully expect the Fed to reduce the federal funds rate no later than September 18. The Fed's first choice would be to see global financial market anxiety decline enough to a point where financial markets work efficiently again. Hence, the Fed would ***not*** be required to cut its federal funds rate at all.

Keep in mind it was only last August 7 that the FOMC kept monetary policy unchanged, with no change in policy since late June 2006. Also at that meeting, the Fed acknowledged rising global anxiety tied to sub-prime mortgage problems with investors, but still indicated that the Fed's primary concern was inflation.

If push comes to shove regarding the need for a cut in the federal funds rate, the Fed would much prefer to do so at a regularly scheduled FOMC meeting, i.e. September 18. However, any sharp rise in global financial market hysteria, and a corresponding drop in American stock prices, would be met quickly by the Fed, with a cut possible any time between now and then.

Our view suggests in either case of a cut that it would likely be a 50 basis point (one-half percent) move, as opposed to the 17 consecutive 0.25% hikes in the federal funds rate between June 2004 and June 2006.

The graph on page one indicates our current best guess of a 0.50% cut on September 18, followed by a further 0.25% cut on Halloween (October 31). We would currently suggest a federal funds rate of 4.50% at the end of the year.

Anyone who tells you how financial markets will perform and how the Fed will respond in coming days and weeks is drinking their own bath water. Forecasting is tough enough when financial markets are behaving rationally. It is fraught with even greater risk when in uncharted waters.

Jeff

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If you must choose between two evils, pick the one you've never tried before.

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