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FedSpeak

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"The outlook for real activity in 2008 has worsened, and the downside risks to growth have become more pronounced. In light of recent changes in the outlook for and the risks to growth, additional policy easing may well be necessary."

"We stand ready to take substantive additional action as needed to support growth and to provide adequate insurance against downside risks."

…thus speaketh the Fed Chairman

The central bank must "*remain exceptionally alert and flexible, prepared to act in a decisive and timely manner and, in particular, to counter any adverse dynamics that might threaten economic or financial stability*."

…he continueth

Preceding comments were taken from a speech delivered by Federal Reserve Chair Ben Bernanke on Thursday, January 10.

20/20 Hindsight

The Federal Reserve has come under additional fire in recent days for being too slow to respond to the serious economic and financial risks faced by the American economy. The combination of 1) a U.S. housing crisis; 2) high levels of domestic and global credit market anxiety; 3) $90+ oil prices; 4) soft December retail sales; and 5) weak December hiring, combined with a higher jobless rate, are a recipe for recession or miserly economic growth.

"*The Federal Reserve is not currently forecasting a recession*," continued Bernanke. "*We are forecasting slow growth. But…it's very important for us to stand ready…to address those risks and provide some insurance against those negative outcomes*."

Thursday's comments by Bernanke were some of the most important of his now two-year reign in the hot seat as the world's most powerful central banker…and arguably the second most powerful person on the planet. His task is not an enviable one in coming months.

A Shift

For the first time, the Fed Chair made it clear that recession avoidance for the U.S. economy is now *Job One*. The Fed's traditional and primary focus on inflation containment will just have to wait.

Federal Reserve Chair Ben Bernanke

The most recent survey of economists conducted by *The Wall Street Journal* places the odds of recession in the next 12 months at 42%, up from 23% just six months ago. Many prognosticators boldly state that recession has clearly already begun, while others suggest the chance of recession remains slim.

The Federal Reserve, like the majority of forecasters in the private sector, felt that the subprime lending fiasco that became highly newsworthy in the late winter of 2007 would not ultimately spread across the economy, nor threaten overall consumer spending. However, he noted, home demand *"has weakened further*" while "*higher oil prices, lower equity (stock) prices, and softening home values seem likely to weigh on consumer spending*."

Fed officials are feeling a bit shell-shocked these days. If such officials would have had the ability last fall to glimpse four or five months into the future…see a combination of three interest rate cuts

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totaling 1.00%, with a likelihood of more aggressive rate cuts to come…they would have expected the Fed to be criticized for being too loose with monetary policy, rather than too restrictive.

A Larger Cut?

It seems clear that the Fed Chair would not have made such aggressive comments about additional monetary ease without a plan to provide same. It is important to note that the Fed does not know what it will do in coming weeks and months…. economic weakness and financial market gyrations will provide the clues.

The Fed has cut its key interest rate—the federal funds rate, currently at 4.25%—three times, with an aggressive 0.50% cut last September 18, followed by lackluster 0.25% rate cuts on October 31 and on December 11.

The Fed's Open Market Committee, or FOMC, the group within the Fed that conducts monetary policy, next meets on January 29 & 30. Market expectations of late December of another 0.25% rate cut to be announced on January 30 rapidly gave way in early January to widely held expectations of a 0.50% cut (referred to as 50 basis points).

Continued volatility/weakness in the stock market, combined with more forecasters embracing the recession view, have now seen financial markets price in a chance of a 0.75% cut (75 basis points) on or before January 30. With enough financial market weakness, a 1.00% cut is not out of the realm of possibility. Note: the Federal Reserve has not reduced its key interest rate by more than 50 basis points in one move since October 1984, a period of more than 23 years. The Fed did trim the rate twice in January 2001 in 0.50% increments.

…we would not be surprised to see the Fed act BEFORE January 30

Transparency

The clarity of Bernanke's comments calls for decisive action. After all, the Fed has traditionally been known as an institution that prefers to keep its views largely to itself, while providing goobledy gook and elaborate prose to financial markets.

Prior Fed Chair Alan Greenspan was considered a master "wordsmith" who made presentations and/or answered questions using byzantine, convoluted, and "labyrinthinian" phraseology. People would often listen to him and walk away… having no idea what was really said.

Over the past year, Bernanke has made numerous moves toward greater Federal Reserve pellucidity and limpidity (sorry…couldn't resist. I mean clarity and transparency).

Self Correcting

We have referred frequently during the past 10 months to a "self correcting" mechanism at play within the economy and financial markets. We noted that in times of strong economic growth, longer-term interest rates tend to move higher to reflect both a chance of Fed tightening and possibly higher inflation pressures around the bend. Such higher interest rates, including higher mortgage rates, tend to slow economic growth. Other times see the opposite result…

…now is one of those times

Fed easing moves to date, combined with high expectations that additional aggressive Fed ease is coming, have led intermediate and long-term interest rates (and borrowing costs) lower. The yield, or investment return, on a 10-year U.S. Treasury Note fell to around 3.70% on Tuesday, its lowest level in nearly four years.

Such a decline propounds (there we go again) and suggests that mortgage rates could move lower still. Note that 30-year fixed-rate conforming mortgages for the week ending January 11 declined to an average of 5.87%, the lowest in more than two years *(source: Freddie Mac)*.

Such a decline in mortgage rates provides greater incentive for those looking to buy a new or existing home, as well as providing a better deal for those looking to refinance a current mortgage… both of which help the current economy.

Jeff

"TEA"ser

The trouble with being punctual is that nobody's there to appreciate it.

—Scott Friedman

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