Tea Leaf

…weekly since 1976

Your guide to understanding today's economy and financial markets

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Slash

Written by Jeff Thredgold, CSP, President, Thredgold Economic Associates

Federal Reserve Chair Ben Bernanke and his Fed sidekicks on Tuesday morning (January 22) delivered what he had suggested on January 10…more "substantive additional action as needed to support growth and to provide adequate insurance against downside risks."

The Federal Reserve announced a 0.75% cut in the federal funds rate before American financial markets opened on Tuesday morning, pushing the federal funds target rate down to 3.50%. This powerful rate cut, combined with three previous cuts since September 18 totaling 1.00%, now finds the Fed as having sliced its most important interest rate by 1.75% since mid-September…

…amazing

…and additional monetary ease is coming

The 0.75% rate slashing was the largest single cut in more than 20 years. The Fed also reduced its much less important discount rate by 0.75% to 4.00%.

Many financial market players interviewed by the media expressed near disbelief that the Fed acted outside its regular Federal Open Market Committee (FOMC) format for the first time in more than six years. On the contrary, we had suggested in both our January 9 and January 16 issues of the *Tea Leaf* that we would not be surprised to see the Fed cut its key rate significantly before January 30 as a means of surprising financial markets.

In Response To…

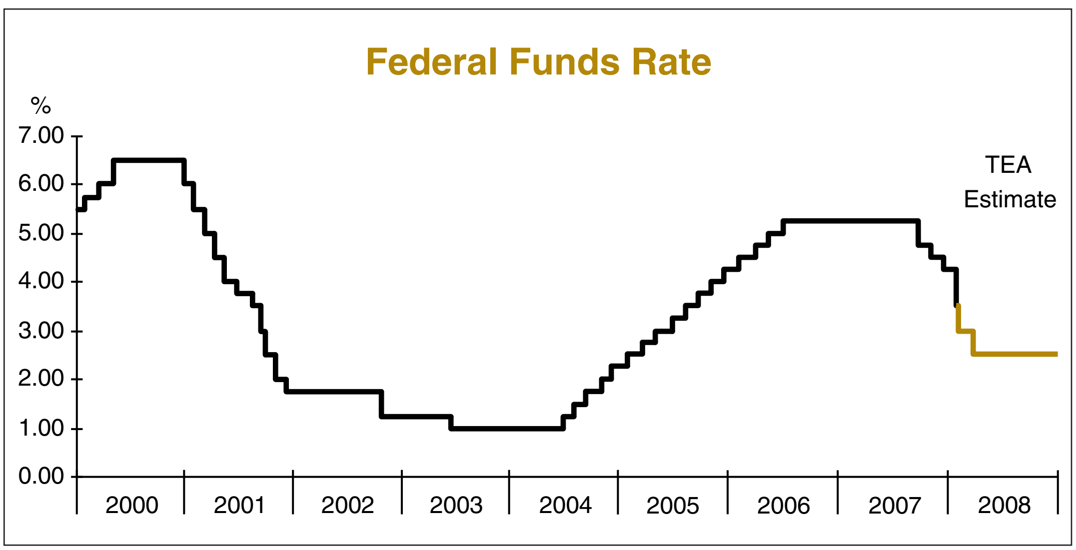
The Fed responded on Tuesday to rising global credit market anxiety that a U.S. recession was more likely to unfold. The Fed was also responding to stock markets around the globe that were hit extremely hard on Monday, January 21.

Making matters worse was the fact that U.S. equity (stock) markets were closed on Monday, with enormous selling pressure likely to be seen as the market opened on Tuesday.

Even after the surprise 0.75% rate cut, the stock market had a very shaky opening, with the Dow (DJIA) average down more than 450 points within 15 minutes of the market opening. However, the market soon "stabilized," with a less emotional and more modest decline the norm for much of the day.

What The Fed Said…

As is usually the case, the Fed provided a statement regarding their aggressive rate cut. "*The Committee took this action in view of a weakening of the economic outlook and increasing downside risks to growth. While strains in short-term funding markets have eased somewhat, broader financial market conditions have continued to deteriorate and credit has*



THREDGOLD ECONOMIC ASSOCIATES

The TEA Company
A Professional Speaking and Economic Consulting Company
1366 S Legend Hills Drive, Suite 150
Clearfield, Utah 84015
801-614-0403
www.thredgold.com

tightened further for some businesses and households.

"*Moreover*," the statement continued, "*incoming information indicates a deepening of the housing contraction as well as some softening in labor markets.*

"*Appreciable downside risks to growth remain. The Committee will continue to assess the effects of financial and other developments on economic prospects and will act in a timely manner as needed to address those risks.*"

Federal Reserve Chair Bernanke has taken considerable abuse in recent weeks and months, with numerous vocal critics arguing that the Fed was "behind the curve" in its conduct of monetary policy. Critics suggested that the Fed just "didn't get it" as far as the complexity and severity of the global financial anxiety that has existed since global markets began to freeze up in August 2007.

Various financial and economic "experts" have described a decline of liquidity in domestic and global financial markets as the primary concern. However, one could argue that it is more a crisis of confidence. Numerous European and U.S. investment firms and large commercial banks have been gun-shy about dealing with other major European and U.S. financial institutions, fearing that such firms may not survive the current enormous write-downs and write-offs of subprime loans and exotic financial instruments.

It's Your Turn…

Pressure now shifts to other major central banks around the globe, particularly the European Central Bank (the ECB). Its key interest rate is currently 4.00%. As noted before, the ECB has a mandate much more focused on inflation containment than does the Federal Reserve.

The 3.1% rise of inflation during the past 12 months within the European community (versus their upside limit near 2.0%) would seem to many to minimize any rate cut possibilities. However, continued European and global financial market stress could force the ECB's hand.

In addition, the Bank of England could cut its key rate, now at 5.50%, again in coming weeks and months. The Bank of Canada did cut its key rate on Tuesday, January 22, by 0.25% to 4.00%…and signaled that at least one additional rate cut is in the cards.

Rising domestic and global financial market paranoia also suggests that proposed fiscal stimulus enacted by the Administration and the Congress could be larger in scope. The idea of relatively quick rebates is rising in stature, combined with some form of business incentives to increase spending.

The Administration wants to limit rebate checks to those who actually pay income taxes, something the Democrats will fight. The Democrats tentatively want to eliminate rebates for those with household incomes greater than $85,000. The Republicans will not go along with this idea…

…perhaps legitimate compromise will be forthcoming

…perhaps not

More To Come…

Financial market players are pricing in additional interest rate cuts by the Federal Reserve in coming days and weeks. Despite the surprise 0.75% interest rate cut of Tuesday, the FOMC will still meet on January 29/30. Many financial market players suggest that another 0.50% rate cut could emerge from that meeting. Others suggest that the Fed will sit tight at the meeting, preferring to see how financial markets respond to this most recent rate cut.

For the moment, we agree with the call for another 0.50% federal funds rate cut on January 30, as well as a further 0.50% cut on March 18. Should such rate cuts occur, the federal funds rate would be at 2.50% in subsequent months, with additional Federal Reserve moves less likely. However, if the recession advocates end up being correct, a federal funds rate at or slightly below 2.00% is a real possibility by the summer…

…stay tuned

Jeff

"TEA"sers

Heard in a courtroom:

-What gear were you in at the moment of the impact?
-Gucci sweats and Reeboks.

-Is your appearance here this morning pursuant to a deposition notice which I sent to your attorney?
-No, this is how I dress when I go to work.

—from *Disorder in the Court: Great Fractured Moments in Courtroom History* by Charles M. Sevilla

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Thredgold Economic Associates
1366 S Legend Hills Drive, Suite 150
Clearfield, Utah 84015
www.thredgold.com

Graphics and layout by Kendall Oliphant
Research assistance by Shawn Thredgold