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Bernanke Won't Hit the Panic Button

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Monetary liquidity is already plentiful, and the normalization of the price of credit risk doesn't threaten growth.

Update to strategic view
FED FUNDS: While the Fed may acknowledge the current credit market turmoil as a risk, it will make it clear that its fundamental policy outlook on growth and inflation is not changed by the normalization of market interest rates from their previous unsustainable low levels. **US BONDS:** Paradoxically, a Fed statement tomorrow which takes a composed and unruffled tone may well help instill a less anxious perspective in the markets, and begin spurring a reversal in Treasuries and other safe-haven plays.
[see Investment Strategy Dashboard]

The Fed prepares to meet tomorrow amid an outbreak of market turbulence the likes of which has not been seen in recent years, prompting all manner of speculation about what policymakers *might* do, and unsolicited advice as to what they *should* do in response. In all probability the Fed will take a highly circumspect approach, loath to signal the likelihood of policy change prompted by a market event that it probably regards as so far having little fundamental implication for the broader economy. As well, the central bank is likely to be cautious lest any signaling of significant concern arouse even greater anxiety among market participants.

It's tempting in these situations to think the Fed has some special power to restore calm, and memories remain of the so-called "Greenspan put" which was exercised during a few of the market upheavals of the Greenspan era. It's important to recognize the difference between monetary conditions prevailing at those times versus those in place today. For the most part, Greenspan ran a tight money regime. Crises such as that marked by the Long Term Capital Management collapse in late summer 1998 were a consequence of the Fed's deflationary policy bent, with the dollar's value relentlessly rising in terms of commodities and foreign exchange, which precipitated a string of emerging market currency devaluations and debt defaults. The Greenspan put was required to reliquefy markets which were seizing up on a dearth of dollar liquidity.

Today we see nearly a perfectly opposite set of circumstances. Far from being scarce, liquidity remains abundant, as captured in the dollar's continued decline against commodities and foreign currencies. The current market turmoil is not a matter of a lack of liquidity but a sudden repricing of risk which had become excessively cheap as the direct result of an easy monetary environment remaining in place even in the wake of the funds rate being hiked from 1% to 5.25% from mid-2004 to mid-2006. And while the price of risk has risen from extraordinarily low

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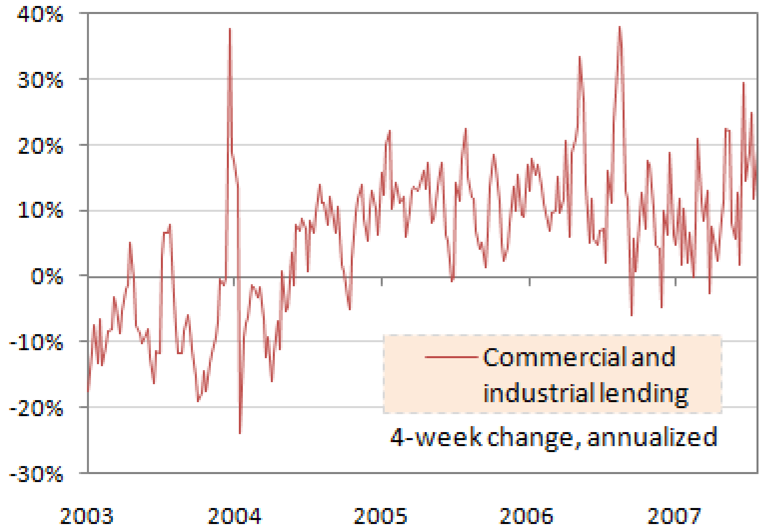
levels, by no means has it become economically prohibitive. In the past month, the Merrill high-yield spread, for example, has jumped by more than 100 basis points, to about 425 bps as of Friday. Over the past 10 years, however, the junk spread has averaged about 500 bps, and current levels have been consistent with solid, sustainable growth. If the spike in such indicators of risk preference were to continue it would obviously spell trouble at some point. But it seems that the worst may have already been seen, as the junk spread has stabilized at about its current level since late last month.



Apart from market segments which are now returning to something approaching normality after riding a wave of excessive exuberance, there is little evidence of a scaling back in activity. On a 4-week annualized basis, for example, commercial and industrial lending is growing at a rate of some 20%, on a par with the best levels of this expansion. The much-discussed "credit crunch" is nowhere in sight. For the Fed, this would tend to counteract any view of the market volatility as presenting real economic risks sufficient to shift its bias away from inflation and toward growth. In recent weeks, various Fed officials, including chairman Ben Bernanke, have conceded that the moderation in core inflation seen in recent months might only be "transitory." In addition, the prior years' downward revision to growth contained in the second quarter GDP release likely buttressed the Fed's view that the economy's non-inflationary "growth potential" is lower than previously believed, and probably is now pegged as being in a range below 3%. Friday's employment report, meanwhile, was widely reported as being lackluster, with a gain of 92,000 payroll jobs. The decline in job growth, however, was largely accounted for by a loss of 28,000 government jobs. Private sector payrolls gained 120,000 positions last month, up from 107,000 in June. Hourly earnings gains, moreover, are running at a 12-month rate around 4%, which is at the upper end of the Fed's limit for "wage inflation." All in all, this is not an environment in which the Fed would be inclined to suggest it is any less alert to inflation risk.

That's not to say that the Fed won't feel compelled to at least offer some acknowledgement of recent market developments -- but it's unlikely to come in the form of suggesting any possibility of an overt policy response. More likely, it will be in the context of noting the recent volatility while maintaining that the outlook for a "moderate pace" of growth remains in place.

BOTTOM LINE: Harking back to the experience during periods of financial market turmoil in Alan Greenspan's tenure, many market participants are envisioning the possibility of a "Bernanke put" being exercised when the FOMC meets tomorrow. We'd bet against it. Unlike the tight money days of Greenspan, there is no evidence suggesting this turbulence has had any connection to a scarcity of monetary liquidity. While from a sound-money perspective we remain skeptical of Bernanke's predilections, we trust that he at least knows enough not to tempt fate during a period when the dollar is already showing signs of significant vulnerability. That is not likely to be good news for Treasuries and interest rate futures, which have seized on the current turmoil both from a short-term flight-to-safety perspective and as a bet that the Fed will be compelled to respond by moving to begin cutting rates in the foreseeable future. A Fed statement tomorrow which takes a composed and unruffled tone may well help instill a less anxious perspective in the markets -- likely diminishing rate cut expectations and at the same time, somewhat paradoxically, begin spurring a reversal in the safe-haven plays.