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FED SHADOW

1% and So What?

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The funds rate has been trading below 1% for weeks, and the Fed has moved beyond rate-targeting anyway.

Update to strategic view
FED FUNDS: The FOMC will cut the funds rate target to 1% at today's meeting, but it will have little practical effect. For the moment the funds target is irrelevant. Funds have been trading below 1% for the last two weeks, as the Fed focuses on providing liquidity directly through its myriad new facilities.
[see Investment Strategy Dashboard]

The Fed no doubt will confirm expectations today and cut the fed funds rate by 50 bp, to 1%. But it's questionable how relevant that move will be in the current environment. As it is, the Fed has for all practical purposes set aside its rate-targeting regime in its present operating mode of open-spigot liquidity injections, which has resulted in a doubling of its balance sheet in the past six weeks. In the process, the funds rate has traded below 1% since mid-month, and hasn't met the 1.5% target since it was adopted in an inter-meeting globally-coordinated move on October 8. The New York open market desk has signaled that it isn't content to see the rate trading so far below target, effecting a string of reserve draining operations over the past few weeks. But given the flood of liquidity being injected in the system through its special facilities and expanded swap lines with foreign central banks, the reserve withdrawals have amounted to little more than symbolic gestures. The Fed has also increased the interest rate it will pay on excess reserves, to build an arbitrage barrier below which the funds rate cannot trade (see "Regime Change at the Fed" October 14, 2008). But that hasn't served to keep the effective funds rate from trading well below the target any more than the open market desk's draining operations have. So as much as anything else, the FOMC will likely be motivated to cut the rate to 1% today to validate the current status of the fed funds market.

Given the reality of its extraordinarily generous liquidity posture going into this meeting, cutting the official rate from 1.5% to 1% probably won't have much practical effect in terms of marginally easing the Fed's policy stance. That stance can only be characterized as maximally easy. With the economy likely at the front edge of recession and against the backdrop of a striking commodity price correction and lingering atmosphere of financial market unrest, Fed chair Ben Bernanke and his colleagues likely are moving inflation risk to back-burner status at this point. Indeed, Bernanke gave his famous "helicopter" speech six years ago in the context of perceived deflation risk at a time when the apparent stresses in the system were far less acute than they are now. But the deflation scare was misplaced then, rationalizing the Fed's descent into an

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ultra-accommodative stance that laid the groundwork for the current market disorder --and it would be misplaced now, as well.

The commodity price moves since mid-summer need to be seen in the context of the intensifying market crisis which drove up demand for the safest, shortest-term assets available -- cash and T-bills -- and forced liquidation of higher-risk positions, including the long commodity plays that had profited so handsomely in the commodity price run-up of recent years. Gold is the purest gauge of supply/demand balance in the market for dollar liquidity, which also makes it the most reliable forward indicator of the inflation outlook. Its retreat from just below $1,000 in mid-July corresponded with the spike in dollar demand driven by the market chaos. Now, amid signs that the crisis atmosphere is ebbing, gold is recovering. At above $760 today, gold has rallied by more than $60 from its worst level a week ago. As accommodative as the Fed is now and is likely to remain for the foreseeable future, the gold price slide is probably over and the upside appears compelling, so long as the path toward market stabilization is sustained. This also suggests that while factors such as the oil price decline will pull reported statistical inflation lower for a time, the underlying fundamentals of the inflation picture haven't changed very much in the last few months. Once the impact of falling oil prices washes through, reported inflation is likely to resume its course higher. It should also be considered that while the rally in the oil price to nearly $150 per barrel last summer was an overshoot on the up side, this correction to a range above $60 is also likely an overshoot on the downside.

As concerned as we remain about the longer-term inflation implications of this extraordinary policy venture, we also have to acknowledge that some of the Fed's efforts have had a highly beneficial payoff. Yesterday's stock market rally was sparked by initiation of the Fed's Commercial Paper Financing Facility, under which some $67 billion in paper was issued, a 10-fold increase from a week ago. As of today, the cumulative issuance under CPFF has topped $100 billion. However, the appropriate course would be for the Fed to sterilize such injections to offset their effect on the supply of monetary liquidity. That is not being done, at least not yet.

BOTTOM LINE: The FOMC will make another 50 bp rate cut today, bringing the overnight target down to 1%, but the practical effect of the move will be limited. The effective funds rate has been trading below 1% for the past several weeks and operationally the Fed has been much more concerned with providing the market with abundant liquidity than with maintaining the target rate. It's worth noting, though, that 1% was also the termination point of the Fed's easing cycle early this decade which laid the groundwork for the credit market chaos which is only now showing some hopeful signs of being relieved.