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FED SHADOW

1/2% Funds: History-Making, But Irrelevant

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Tomorrow's likely record low funds rate has little to do with how the Fed now operates.

Update to strategic view

FED FUNDS: Tomorrow afternoon's likely announcement of a 1/2% funds rate will garner much media attention as an historic low for the overnight rate target, but will have little practical meaning. The Fed is now in a quantitative easing regime -- but it is unlikely to reveal many details about its operating parameters tomorrow.

[see Investment Strategy Dashboard]

The Fed tomorrow will in all probability cut its funds rate target to an all-time low of 1/2%. The rate move, though, will amount to little more than a symbolic gesture, meant to signal that it is intent on doing everything possible to restore growth, stabilize markets and root out any potential deflationary influences that may be at work. Fact is, the rate has not traded at target in more than two months, and for all practical purposes the Fed is now operating a quantitative easing regime, setting aside its rate-targeting procedures as it expands its balance sheet at an eye-popping rate to pump enormous sums of liquidity into the financial system.

For a good part of the period after the credit market storm erupted in mid-September, the Fed's actions could largely be seen as endeavoring to meet the exogenous spike in dollar demand arising from the asset liquidation panic, to act as a lender of last resort to preserve some semblance of liquidity in troubles markets such as commercial paper and money market funds. Reflecting the safe-haven rush to cash, the price of gold fell from about $820 just prior to intensification of the market turmoil in September to as low as $780 at its bottom in late October, with the dollar rising against the euro from €1.42 to €1.25. Since then, gold has rallied to about $840, and the dollar has retreated sharply in forex markets, with the euro back above €1.36. This reflects both the emergence of some measure of calm in the markets, easing the demand for dollars -- as well as the burgeoning supply of dollars coming from the Fed, as the Fed's mission has expanded from market-liquefying to deflation fighting (see "Deflation Takes Center Stage" November 19, 2008).

For now, we're inclined to view this, on balance, as a good thing. The Fed getting ahead of the curve on the surge in dollar demand pretty well obviates any significant risk of a deflationary outcome to this episode (see "Why Isn't Gold at $1500?" December 10, 2008). Yes, there are deflationary influences still at work: cash demand remains elevated as the de-leveraging and de-risking process grinds on. But with the Fed more than meeting that demand, the trend-shift lower for the dollar should continue, rendering deflation an increasingly unlikely prospect.

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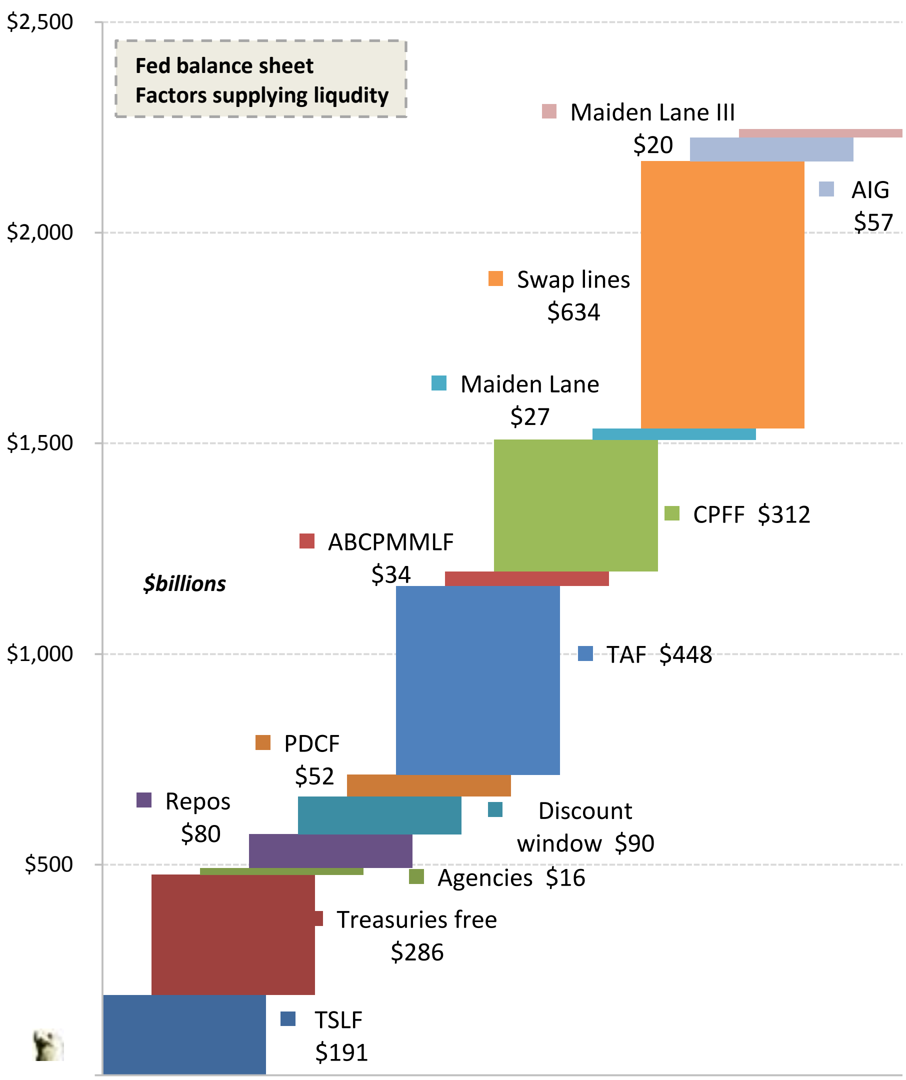
Indeed, as much as the Fed's balance sheet has ballooned the past few months -- with "factors supplying reserves" now standing at almost $2.3 trillion, more than double its size in mid-September -- the rate of expansion could actually accelerate in the weeks to come. The roster of the Fed's liquidity-adding mechanisms continues to grow -- it is committed to purchasing $600 billion of mortgages and mortgage-backed securities, is initiating a $200 billion lending program to support securitization of asset-backed consumer and small business loans, and, [according to](#) Fed Chairman Ben Bernanke is likely to begin purchases of "substantial quantities" of Treasuries (see ["Feeding Frenzy in Treasuries"](#) December 2, 2008). Moreover, the Special Financing Program, under which Treasury deposited some $559 billion with the Fed raised by sale of short-term bills, is now running off. This was a liquidity-draining factor, so as the bills mature it has the effect of adding assets to the Fed's balance sheet.



The Fed has broached the possibility, reported last week by the *Wall Street Journal*, of issuing its own debt instruments, presumably as a means of sterilizing some of the liquidity it is now creating at such an accelerated pace. However, such a step would require action by Congress, and with the Treasury now having such prodigious borrowing needs of its own, lawmakers may not be anxious to sanction a competitive debt issuer. In any case, even if the authorization were granted, it's not likely that the Fed would want to issue enough debt to reverse much of the recent growth of its balance sheet. Their objective in pursuing that growth, after all, has been to expand the availability of liquidity.

At some point, the markets will stabilize and the panic will recede, as will the heightened demand for cash, and that will raise potentially inflationary implications of the Fed's expansive liquidity posture. The question then will become whether the Fed is nimble enough recognizing the shift to expeditiously draw down the liquidity that has been added to confront today's crisis conditions. But "nimble" is not a word usually associated with the Fed. Much more often than not, the central bank has been slow to respond to changing conditions, which explains why it is usually conducting policy to correct for a previous policy error. And in this case, it is likely to be cautious in instituting a significant policy shift for fear of reigniting the market turmoil. We continue to see a significant uptrend in inflation as the most likely consequence of this policy cycle.

Given that the Fed is now operating under a regime that has been so radically altered from traditional rate-targeting, the FOMC will probably include some recognition of the change in tomorrow's announcement. However, it will probably be as sketchy and unspecific as they can justify, inasmuch as the policymakers at this point likely are themselves very unsure of the principles guiding the policy setting in which they now operate. This is a time of learning by doing for the Fed, which creates the potential for big mistakes.

BOTTOM LINE: Tomorrow afternoon's likely announcement of a 1/2% funds rate will probably garner much media attention as representing an historic low for the overnight rate target but will have little practical meaning. The Fed is now operating a quantitative easing regime, and as shown by the recent softening of dollar purchasing power, it has injected enough liquidity to overcome the exogenous cash demand arising from the financial market crisis. That has all but eliminated any realistic risk of deflation, but is setting the stage for what is likely to be an episode of considerably higher inflation.