Market Insight Series

Market Bulletin

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Investment Implications of the Fed Rate Cut

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Fed Announces Emergency Rate Cut

Yesterday the Federal Reserve took the rare step of announcing a cut in the federal funds rate, from 4.25% to 3.50%, between its regularly-scheduled Federal Open Market Committee meetings. Since 1994, the federal funds rate has been changed 53 times but only four of those moves (three cuts and one increase) have come between regularly scheduled meetings. That being said, this emergency action could not be characterized as a complete surprise since futures markets had clearly priced in at least the possibility of just such a move.

Why the move?

In their statement, the Fed said they were taking this action "….in view of a weakening of the economic outlook and increasing downside risks to growth". While they noted that they would continue to monitor inflation developments carefully, it is clear that they are more concerned about recession than inflation. They also said that they 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".

What does the Fed's action mean for investors?

• This move does little to reduce recession risks.

The problem is that most of the modern U.S. economy is just not that sensitive to interest rates – a fact which was hammered home by the very slow start to the expansions of the 1990s and 1980s, despite heavy doses of monetary stimulus.

Home-building should eventually benefit from lower rates. However, any recovery in housing will be impeded by the reality that most market participants will expect further rate cuts (as was the case after previous "between-meeting" rate cuts). Whether you are a potential buyer, seller or builder, it makes sense to delay action if you feel cheaper financing is going to be available a few months down the road. The more general problem facing the American economy today is a lack of business confidence. The Federal Reserve's grim assessment of business conditions, which is implicit in their move and statement yesterday, will do nothing to alleviate this situation.

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- **Any recession, if it occurs, should be brief.**

  Normally, when the U.S. economy enters a recession, it is because of a collapse in demand, which leaves factories and offices overstaffed, leading to job cuts, which in turn, trigger spending cutbacks. However, today, America simply is not overstaffed. Demand has held up well, with GDP growth of close to 3.0% over the past year, and, while consumer spending seems to be slowing somewhat, exports continue to boom and the much battered home-building sector should be close to hitting bottom. Because of this, many business sectors will find it hard to reduce headcount, and, barring some other major financial or geopolitical shock, any U.S. economic slowdown should be shallow and brief. This prognosis is further bolstered by the increasing likelihood of big tax cuts before the middle of the year, as suggested by both the President and Congressional leaders last week.

- **The stock market may have overreacted to the recession threat.**

  Even with market volatility, economic weakness, and a somewhat ineffective Federal Reserve, the outlook for financial markets may not be that bleak:

  - Lower interest rates should eventually be a big positive for financials, (which have led the recent stock market correction) as financial institutions can once again make a profit from borrowing short and lending long, and credit spreads have been restored to more economically sane levels.
  - Lower short-term rates and a diminished threat of wage inflation should help the bond market, although Treasuries continue to look expensive.
  - International investments can benefit from a continued decline in the U.S. dollar as lower short-term interest rates reduce the attractiveness of dollar-denominated assets.

  Perhaps most importantly, the recent stock market slump, combined with low core inflation, low interest rates, and low taxes on equity returns, has left U.S. stock prices at some of the cheapest valuations seen in the last 30 years. Because of this, while yesterday's Fed action may not represent a silver bullet for either financial markets or the economy, long-term prospects for the U.S. economy and financial markets remain positive, and long-term investors should be best served by sticking to a long-term investment plan.