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Monday Morning Outlook

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Another Ride on the Fed's Asset-Centric Rollercoaster

In a highly unusual move, the Federal Reserve announced on Sunday that the discount rate had been cut by 25 basis points and that it had approved the JPMorgan – Bear Stearns deal. In addition, it created another new lending facility for primary dealers, which appears to be open-ended in dollar terms and is available immediately.

At virtually the same time, it was announced that JPMorgan would acquire Bear Stearns for $2 a share, or $236.2 million. This is a huge shock. Bear Stearns had a market cap of over $20 billion about a year ago. A little later on Sunday, Carlyle Capital announced that it would liquidate its entire portfolio of mortgage securities. The Wall Street Journal reported that Carlyle Capital had $940 million of client money, but levered that by as much as 24 times and held $22.7 billion of mortgage bonds.

These developments show that without liquidity and capital, financial institutions and trading vehicles are in trouble. These developments also show that aggressive Fed rate cutting has been ineffective.

And while more rate cuts are likely, we believe they are a mistake. Interest rate cuts since August have been counterproductive. They have created an incentive for businesses and consumers to postpone activity. Why do something today if rates will be lower next week or month? In addition, lower interest rates have undermined earnings at banks by causing all adjustable rate loans (tied to prime for example) to move lower. Cutting interest rates at a time of heightened risk also undermines the willingness of some investors to stay invested – think repos, or auction rate preferred securities.

From the beginning, the Fed should have used things like the Term Auction Facility for commercial banks or today's lending vehicle for primary dealers. They should have been more like the European Central Bank.

Unlike rate cuts, these actions, by themselves, do *not* result in a looser monetary policy. They simply focus liquidity where it's obviously needed the most.

The root cause of the Fed's mistake is that for the past ten years it has been asset-centric rather than inflation-centric. This asset-centrism started in the late 1990s when despite rampant signs of deflation (like falling gold prices), the Fed raised rates to prick the stock market bubble. The market did not respond right away. In fact, tight money made the dollar strong and made US investments very attractive. Eventually, however, tight money cracked the market severely and caused deflation

The rollercoaster continued in 2002-03 when the Fed cut rates to 1% to offset the NASDAQ collapse and prevent a Japanese-style deflation. The Fed pushed rates below inflation and held them there despite the fact that rising gold prices were signaling the threat of deflation had passed. Perhaps even worse was the way the Fed dragged its feet in raising rates even as CPI inflation went from 2% to 4% and gold was hitting 25+ year highs. As a result, the Greenspan policy of accommodation and gradualism caused a housing bubble, which in turn created today's mess.

Despite all this, the Fed has still not learned. It is focused on asset prices again, not inflation. How else to explain the absence of "price stability" as a goal listed in its post-meeting statements, even as CPI inflation is near a 17-year high, producer prices are up more than at any time since 1981, import prices have been rising at a record pace, and the dollar falls? This rollercoaster ride makes recovery from current problems even more difficult.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
3-17 / 7:30 am	Empire State Index – Mar	-6.0	**-5.0**	-22.2	-11.7
7:30 am	Current Account Balance – Q4	-$183.8 Bil	**-$185.2 Bil**	-$172.9 Bil	-$178.5 Bil
8:15 am	Industrial Production - Feb	-0.1%	**-0.1%**	-0.5%	+0.1%
8:15 am	Capacity Utilization – Feb	81.3%	**81.2%**	80.9%	81.5%
3-18 / 7:30 am	Producer Prices – Feb	+0.4%	**+0.6%**		+1.0%
7:30 am	"Core" Producer Prices - Feb	+0.2%	**+0.1%**		+0.4%
7:30 am	Housing Starts - Feb	0.990 Mil	**0.983 Mil**		1.012 Mil
3-20 / 7:30 am	Initial Claims - Mar 15	359K	**353K**		353K
9:00 am	Philadelphia Fed Index – Mar	-18.0	**-20.2**		-24.0
9:00 am	Leading Indicators - Feb	-0.3%	**-0.3%**		-0.1%