



# Market Flash

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## FEDERAL RESERVE SIGNALS END OF EASING CYCLE

By Markus Schomer, Global Economic Strategist

The Federal Reserve lowered its target for the Federal Funds Rate by a quarter percentage point to 2% on April 30, 2008, at the same time signaling that the period of aggressive rate cuts is likely over. Since September of last year, the Fed has cut interest rates eight times—twice between regularly scheduled meetings—by a total of 325 basis points.

Financial markets had widely expected the 25 basis point rate cut. Of the 73 economists regularly polled by Bloomberg, only nine were looking for a half-point cut, and two actually predicted no change. No change is also what Dallas Fed President Fisher and Philadelphia Fed President Plosser wanted; hence their dissenting vote against the rate cut. The same two also preferred a less-aggressive action at the previous FOMC meeting in March.

Investors often pay a lot of attention to the policy statement issued with the rate decision, which lays out the key drivers of the FOMC's decision and represents a forward-looking statement that Fed watchers use to predict its next moves. The most important change was the removal of the key risk-related phrase that read “*downside risks to growth remain.*” This phrase had been part of the statement since the intra-meeting rate cut on Jan 22 and had signaled further rate cuts at subsequent meetings.

The most recent statement indicated a move to a more data-dependent strategy, when it was noted: “*the Committee will continue to monitor economic and financial developments,*” and didn't provide a clear message about the Fed's next move. The statement also read, “*... [the Committee] will act as needed to promote [...] economic growth and price stability,*” which is a complicated way of saying the Fed has switched gears to neutral.

In the statement, the Fed describes a mixed inflation backdrop with recent inflation indices improving, but commodity prices still trending higher, and inflation expectations deteriorating. Interestingly, the Fed expects inflation pressures to ease in the coming months, as a result of a leveling-out of commodity prices.

We are more skeptical about the inflation backdrop and expect the recent run-up in energy and food prices to lead to a more broad-based increase in inflation, as companies try to pass on rising cost pressures to the consumer—a good example is the rise in fuel surcharges on airline tickets. The Fed's outlook for U.S. growth remains very cautious, as evidenced by several key phrases: “*... economic activity remains weak,*” “*household and business spending [...] subdued,*” “*labor markets have softened further,*” and “*financial markets remain under considerable stress.*”

Clearly, the recent rebound in equity markets has removed the immediate pressure on the Federal Reserve to use monetary policy to shore up investor confidence. The aggressive provision of additional liquidity to the banking sector and the widening of the Fed's safety net to brokerage firms, following the Bear Stearns collapse, represented important measures that stabilized financial markets. The focus is now shifting back to the economy. The most recent GDP report for the first quarter highlighted the weak underlying growth momentum, suggesting that further stimulus is necessary. However, the Federal Reserve will most likely want to wait and see what impact the arrival of tax-rebate checks have on consumer spending in the coming months.

Where do we go from here? Unless the economy deteriorates further, we believe the Fed will keep rates unchanged from here on out. Our base-case scenario for the rest of the year is a modest rebound in economic growth in the second half, driven to a large extent by stronger consumer spending (tax rebates), and renewed growth in business investment, which also benefits from provisions in the fiscal stimulus package.

Inflation will remain on the front pages, even if commodity prices ease somewhat over the summer. High gas prices, for example, are not just the result of rising oil prices, but also supply constraints in refinery capacity, which will keep gas prices high for most of the year. In fact, we believe the next move for the Fed is likely to be a rate hike before the end of the year. The Fed is poised to start the slow process of removing the excess monetary stimulus that was necessary to avoid a meltdown in the financial markets, but which could create further problems down the road.

Financial market expectations adjusted quite smoothly in recent weeks, due to a potential signal the Fed was done cutting interest rates, which made the rate decision a fairly easy one, with little reaction in stock and bond markets. Preparing financial markets for a potential rate increase later in the year will prove a much more difficult task, especially if Chairman Bernanke wants to avoid the criticism now heaped on his predecessor for keeping interest rates too low for too long in 2004, following the deflation scare in the previous year. Alan Greenspan's hesitation to remove the excess monetary stimulus quickly was at least partially responsible for the lending boom in the housing sector that eventually triggered the current crisis.

## Bottom Line

This last rate cut to appease recession fears is a strong signal that the period of aggressive Fed action is over. It is now time to let the prescription (both monetary and fiscal) do its work and reassess the situation in the summer.

We believe the Fed has done enough at this point. In the coming months, the economy is likely to rebound on the back of strong exports, improving financial market conditions and tax-rebate-driven consumer spending. However, we believe rising inflation pressures in the coming months will initially force the Federal Reserve to change its rhetoric and eventually start an interest-rate-normalization cycle that will dominate financial markets trends in 2009. ■



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