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STEP 1: FED RATE CUTS.

STEP 2: TALK OF RATE CUTS “NOT WORKING”.

STEP 3: MORE FED RATE CUTS.

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STEP 4: INFLATION WORRIES RETURN.

We’ve now seen “step 1”, which is that the Fed has cut the target fed funds rate, as economic data has turned to the weak side (eg, the Aug payroll employment report). The Fed’s transparent move of opting for aggressive -50bp cuts in both the fed funds target rate and the discount rate clearly helped confidence, based on the market reaction. **The language in the Fed’s statement suggested that additional rate cuts were possible, though inflation concerns remained.** It is worth noting, however, that the FOMC hawks were content to simply add a single, noncommittal sentence to the statement concerning vigilance with respect to inflation – “the Committee judges that some inflation risks remain, and it will continue to monitor inflation developments carefully.” – before voting unanimously for a -50bp cut.

What lies in the immediate future is probably the realization that fed cuts affect the economy with a lag. “Step 2,” is probably increased talk of Fed rate cuts “not working” or its actions akin to “pushing on a string”. Our baseline forecast, however, is that the Fed cuts do eventually work. Since we cannot count on a shallow recession, if one starts, the Fed chooses to ease aggressively to help stave off economic contraction – and this is currently occurring in an environment where corporate balance sheets remain in good shape and the restrained labor share of income suggests that profit imbalances are not severe. We continue to look for the fed funds rate to be down to 4.25% by 1Q of 2008, and put the chance of recession at 30%.

Given the continued focus on “some” inflation risks, however, it seems possible that if the economy stabilizes, fed rate cuts could be taken back quickly. One additional takeaway from the recent Fed move is that Chairman Bernanke – in a break with former Chairman Greenspan – has shown a willingness to make large “catch-up” moves at scheduled FOMC meetings, rather than smaller moves inter-meeting. While inter-meeting moves still remain a possibility, as do additional moves to facilitate liquidity, the next scheduled meetings on October 30-31st and December 11th should gain additional importance in this environment.