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Faint Hearts and the Queen of Spades

The current monetary policy debate suggests a fruitful analogy with the ancient game of "Hearts." One typically passes Queen of Spades so as not to get "stuck" unless one chooses the option of "shooting the moon." The monetary equivalent of passing the Queen of Spades is of course to "treat" Sub-prime Credit Crisis. The Market is calling for at least a 25 bp cut today, in spite of much evidence that the economy is not in recession and many signals that inflation is not dead, here or elsewhere in the global economy.

Cutting the Fed Funds rate would be a way of signaling the market that the Fed is not about to risk a Mervyn King-like policy of 'starving the [inflation] beast,' for reasons of moral hazard. Who can blame the Bernanke Fed for shrinking before the small risk of a credit infarct and ultimately putting the Recession word front and center? Bernanke's own research did much to fill in the lacunae of how a deep economic calamity could first begin with a stock market crash and then via credit contraction deepen into a major economic calamity. Further work on the so called "credit channel" and the financial accelerator has suggested routes by which monetary policy can affect the economy. Without question, his studies deepened our understanding of the workings of monetary policy. Those same concerns legitimately focus on whether Bernanke's expressed sentiment that the Fed "will never do that again," is the appropriate metaphor for today's data constellation?

The current signals coming from the data flow do not suggest a recession suddenly emerging. True, consumer confidence has fallen sharply, but there is a difference between measures of consumer confidence and sharp reductions in the rate of consumer expenditure expansion. There are indeed some signals that run of the mill consumer product sales might be weakening. (The P&G earnings report will be noted since a mighty fall in P&G earnings reported in March 2000 did in fact presage the sharp equity that followed). Additionally, there is anecdotal evidence of worry in the business sector. While this Fed has from time to time indicated that it is not there to bail out the equity market, its worries over a long housing decline have been made known. The market has inferred that the current level of the Funds rate is too high and that the Fed will lower it today. The problem is that in lowering the rate the Fed is forced to ignore some disturbing signs of inflation.

Clearly the price of oil is creeping into Fed considerations. It does so because high and rising oil prices work their way into higher top line inflation measures causing greater deviations between core inflation and top line measures. The Fed has based its current preoccupations on core numbers on the grounds that over time, core measures are better predictors of inflationary pressure. But that interpretation is weakened by a long standing divergence between those two measures. Equally, the price of gold and the falling dollar/euro exchange rate are also "signals" of inflationary expectations. The issue is what will dislodge the currently "well-anchored" inflation expectations that the Fed counts upon. Finally, there are disturbing signals from some of the other sources of world economic growth that inflationary pressures are building (e.g. in India and China). The question of the day is whether the signals of world wide inflation are going to emerge as the stronger force over the current concerns that recession may indeed breakout in the future in the U.S?

The Fed has to be concerned today about how the housing deflation will work itself out and even though it claims not to target asset prices, a policy that is supportive to equities and perhaps to lending is effectively to pass the Queen of Spades. To do otherwise---and sit tight---- might ultimately prove to be the better course. But Fed Chairmen—and Central Bankers in general---are usually not applauded for being overly tough on inflationary pressure and perhaps weakening asset markets. It might be the right course, but it would not be a a popular one at least in the short run. Yet, some monetary savants are arguing that the Fed will "have to take these cuts back." Taking them back will deteriorate claims by this Fed that is being transparent and credible. In our view, this Fed will pass that ugly Queen today. The other choice is to shoot the moon---and that seems too risky a course for this Fed. Despite its economists, it is still a political institution.

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P.O. Box 749, Horsham, PA 19044

Website www.ecomentary.com. Contact: munkb@ecomentary.com