



*The right solutions
at the right moments.*

Blink*

*December 2007
Investment Commentary*

In last week's *Weekly Market Beat*, I mentioned that "the tipping point for the Fed is fast approaching." No sooner was the ink dry on that scribbling when the two senior Federal Reserve Board policymakers, Vice Chairman Donald Kohn and Chairman Ben Bernanke *finally* publicly admitted things have gotten worse since the end of October.

As detailed last week, yield spreads among credit market rates and the Federal funds rate have risen back to their levels in mid-August, before the Fed began cutting the Fed funds and discount rates. Last week, the Fed belatedly acknowledged what the markets have been discounting for a month – financial conditions are deteriorating, lending standards are tightening anew, and the effects of the mortgage meltdown and housing bust are spreading to other parts of the economy. On Wednesday, a speech by Vice Chairman Kohn began to set the markets up for a change in the Fed's thinking about the ongoing risks in the financial markets:

"Conditions in the [inter-bank] funding markets have deteriorated in recent weeks....and the uncertainties in the economic outlook are unusually high right now. In my view, these uncertainties require *flexible and pragmatic* policymaking..."(italics mine)

And last Thursday night, in a speech in North Carolina, Ben Bernanke made the following revealing comments about how conditions have changed since the Fed's last rate cut at the end of October:

"...the outlook has been importantly affected over the past month by renewed turbulence in financial markets, which has partially reversed the improvements in financial markets in September and October....Credit losses and mortgage write downs...have resulted in a further tightening of financial conditions, which has the potential to impose additional restraint on activity in housing markets and other credit sensitive sectors....We at the Federal Reserve will have to remain *exceptionally alert and flexible*..."(Italics mine)

I believe the italicized phrases are code words for a coming further policy change by the Fed. The similarity in phrasing is a dead give-away that the Fed is expecting to cut the Fed funds rate on December 11 by at least 25 basis points and possibly more. The markets took heed of all of this; by week's end, the Dow rose 3.0%, the S&P 500 gained 2.8%, and the Nasdaq was ahead by 2.5%. Financial stocks rose sharply, up 9.5% from their lows on Monday. Moreover, the dollar gained nearly 2% from its multi-year low earlier in the week.

While another cut in the Fed funds rate may not cure the mortgage mess, I believe it will align the Fed's decision-making with the realities that serious dislocations in the credit markets can have a severe impact on reducing economic growth more quickly than expected. By holding their benchmark rate too high relative to the requirements of the credit markets, they are creating needless uncertainty and risk aversion among market participants involved in daily funding of liquidity needs. It now looks like reality will set in.

One important consequence of the Fed's return to reality last week was the action in the dollar. Typically, Fed indications of another cut in rates would pressure the dollar lower. Not this time. As the accompanying chart shows, there may have been a breakout from the downtrend that has been in place for some time. The bottom clips show that while the dollar was falling, its downward momentum was waning – prelude to a bottom. The sharp drop in oil and gold prices last week were probably a casualty of this strength in the dollar.



The market may now be sensing that the Fed's "blink" this time will create a cushion for an economy that is losing steam. As the Eurozone economy is beginning to slow on the back of over-valued currencies and their own central banks' refusal to ease because of overblown inflation fears, the U.S. may start looking like a better economic and investment prospect for 2008. What gives me some confidence that the dollar may be making an important bottom is the always-wrong financial magazine cover stories on economics and markets. Look at two recent magazine covers below on the plight of the U.S. dollar....Priceless.



Source: Briefing.com

*Quite coincidentally, someone alerted me to the fact that last week's *Weekly Market Beat* and this month's *Investment Commentary* bear the titles of two recent excellent books by Malcolm Gladwell, whose subject matter is not wholly far a-field from the present context – how little things can make a big difference, and that the great decision makers aren't those who process the most information or spend the most time deliberating, but those who can filter the very few things that matter from an overwhelming number of variables. Maybe Ben Bernanke and crew should consult Mr. Gladwell.

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