Will Katrina Swamp Fed's Plans?

"The best-laid schemes o' mice an' men gang aft agley"—Robert Burns

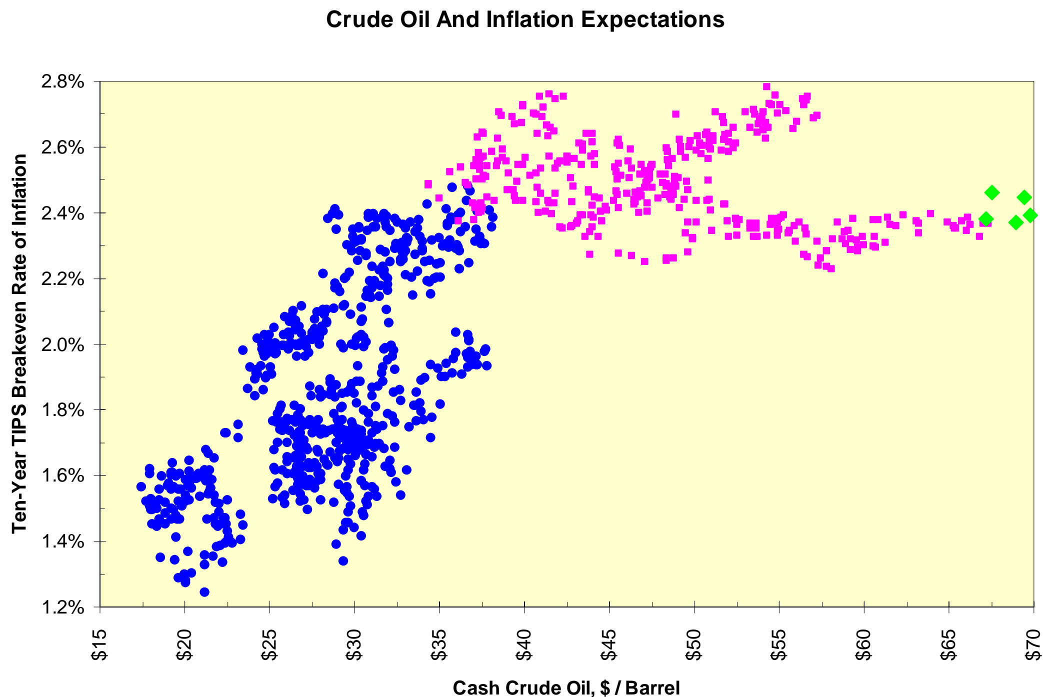
The Federal Reserve has spent the better part of the past year telling the market of its plans to raise interest rates 25 basis points at every meeting, come hell or high water. Now that Hurricane Katrina inflicted both contingencies upon residents of the U.S. Gulf Coast and to all those dependent on their resources and services, the course of monetary policy will be affected with risks running high no matter what the outcome.

Let's start with a conclusion and work our way backwards: The Federal Reserve's tightening of credit since April 2004 – yes, the first rate hike did not come until June 30, 2004, but the course had been established on April 2nd with a strong employment report for March – prevented the doubling of crude oil prices since that time from upending financial markets. While it is true, as has been noted here and elsewhere, the surge in oil prices up until Katrina was the result of strong demand driven by global economic growth, it was the Federal Reserve's refusal to repeat its mistake of the 1970s, offsetting higher energy prices with easier credit that forestalled financial stress.

We can illustrate this by mapping a series of financial markets' performance against cash crude oil prices. The data are divided into three time segments. The first, illustrated with blue dots, corresponds to the period between September 17, 2001 and April 1, 2004. During this period crude oil prices rose, especially in the period surrounding the Iraq War, but the real environmental variable was low short-term interest rates. The second period, illustrated with pink squares, corresponds to the April 2, 2004-August 26, 2005 period, one in which the Federal Reserve increased short-term rates ten times. The third period, illustrated with green diamonds, is August 29-September 2, 2005, the period wherein crude oil prices shot to new record highs and the financial markets began to doubt whether the Federal Reserve could or would maintain its course.

A Tour Of Markets

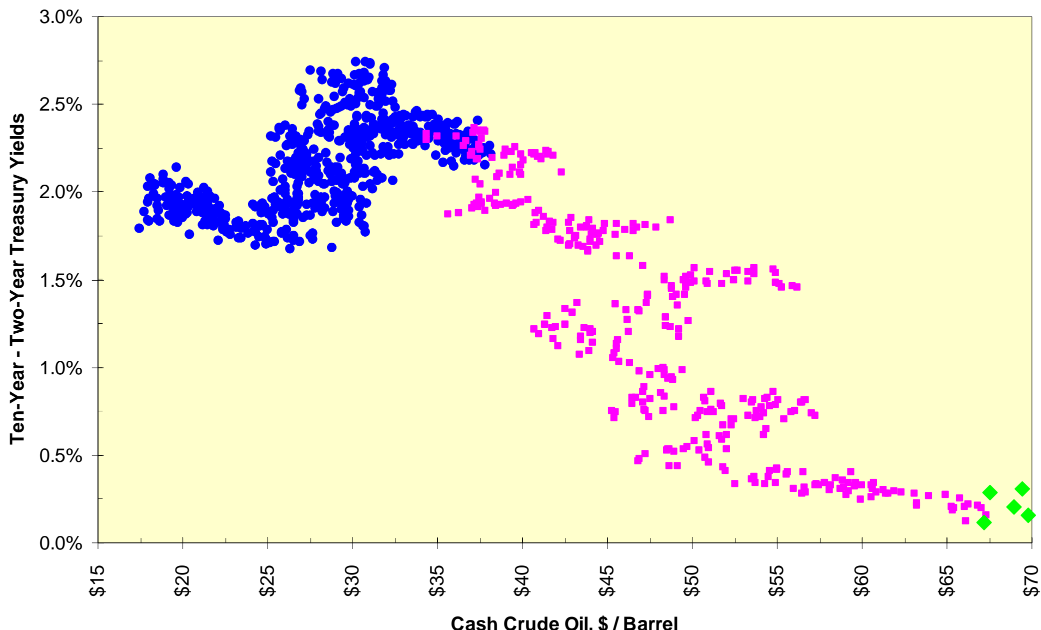
The first and most important market is inflation expectations, as measured by the yield spread between ordinary ten-year notes and TIPS. This breakeven rate of inflation rose during the rate-cut era, but paused and actually began to decline as the Federal Reserve tightened and the yield curve flattened. From Wednesday to Friday, it increased from 2.3711% to 2.4602%.



The Yield Curve

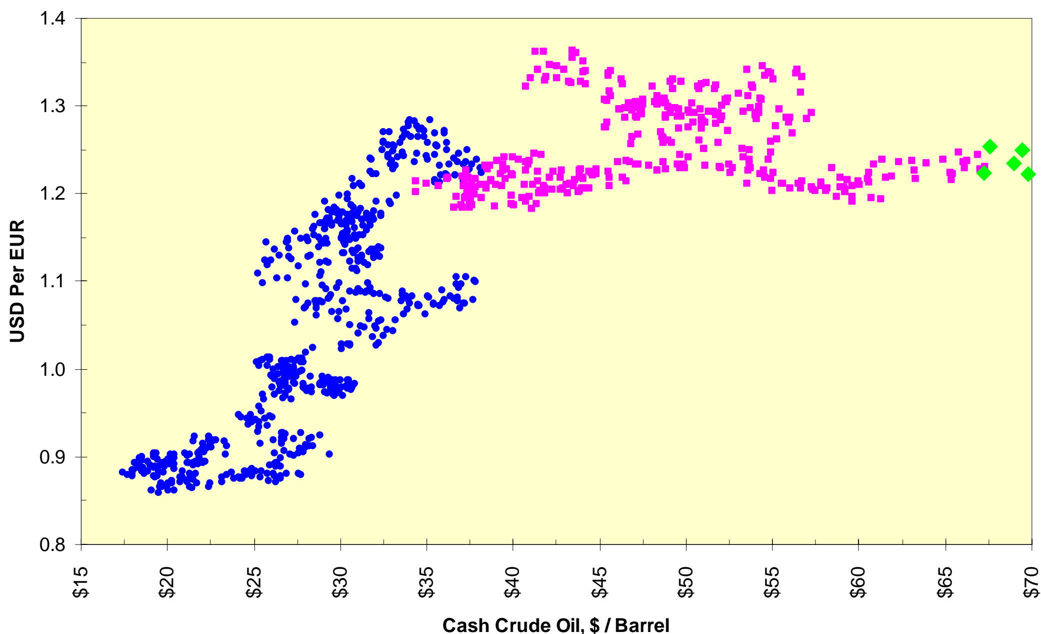
The yield curve, as measured by the spread between ten-year and two-year Treasury notes, steepened prior to April 2004 under the weight of monetary ease. Once the Federal Reserve began to tighten the curve narrowed as long-rates fell slightly and the two-year yield rose significantly. If higher crude oil prices contributed to increased

inflationary expectations and a steeper yield curve, it was hardly apparent. It was this bullish flattening of the yield curve, the drop in long-term rates, that kept the economy perking along – the famous "conundrum." No more: The two-ten segment of the curve steepened from 11.523 basis points on Monday to 28.173 basis points on Friday.



The Euro

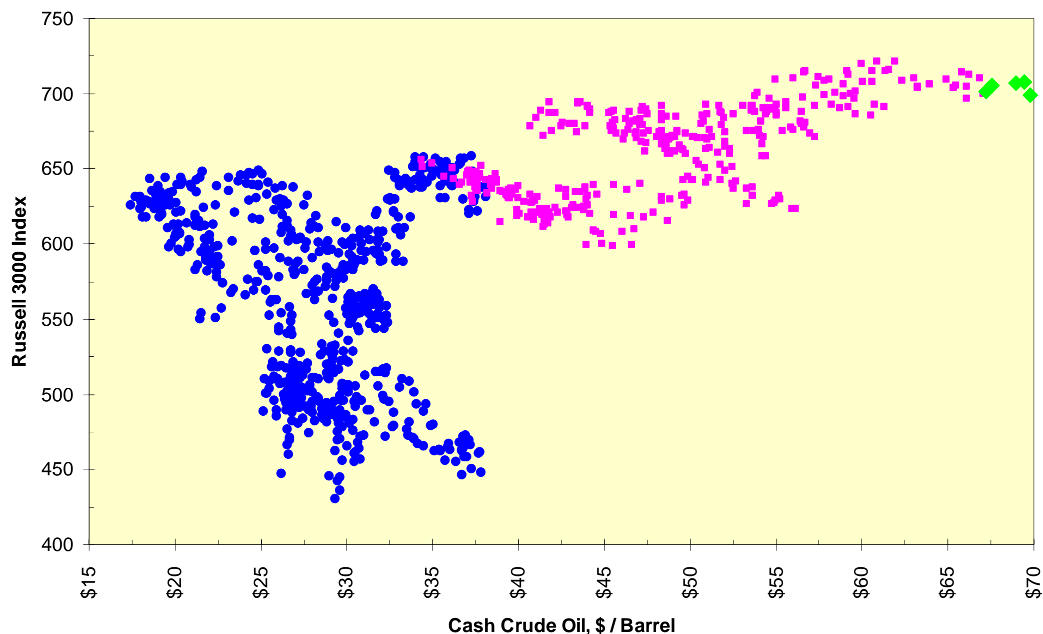
If the Federal Reserve is going to create more dollars, then each dollar should be worth less in the absence of increased domestic demand. The euro strengthened significantly against the dollar between September 2001 and April 2004, but then leveled off into a totally random relationship to crude oil thereafter. The euro jumped from 1.2234 on Monday to 1.2531 on Friday.



U.S. Stocks

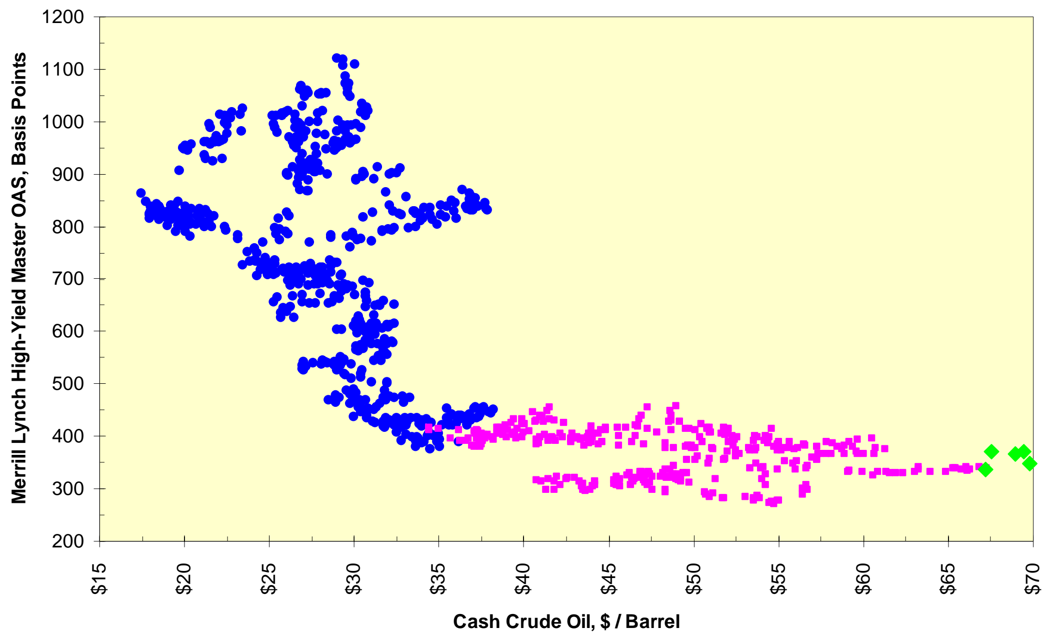
Certain business-oriented television networks keep flashing the current price of crude oil in the "bug" in the lower-right-hand corner of the screen. The implication, extant for more than a year now, is crude oil prices are so critical

for stocks that constant monitoring is a good idea. That may have been true between September 2001 and April 2004, when the Russell 3000 fell as crude oil prices rose, but that certainly has not been true since. From April 2004 onward, the Russell 3000 index has risen despite – because of? – higher crude oil prices. The index rose again last week, with the biggest portion of that gain, from 698.97 to 706.84, occurring on Wednesday, the day when the magnitude of the Katrina catastrophe really became apparent.



High-Yield Bonds

Now let's turn to a subject addressed last week, stress in the corporate bond market. If higher crude oil prices pinch consumer spending and increase everyone's cost of doing business, two reasonable assertions, then they should also lower the credit quality of the most vulnerable firms. Nice theory, but no evidence in support of it: The option-adjusted spread (OAS, a measure of a bond's risk) of the Merrill Lynch High Yield Master index fell consistently between September 2001 and April 2004, and then declined slightly into last week even as crude oil prices shot higher and short-term rates rose. The measure rose 33 basis points, or nearly 10%, last week.



From Conundrum To Dilemma

We can see from the above how the post-September 11th financial markets were able to ignore the effects of higher crude oil prices and how many of the real gains occurred not during the Federal Reserve's grand experiment in lower rates, but after it began to raise rates in a steady, predictable and resolute manner.

Katrina represents an enormous shock to the U.S. economy, and given the precedents of the Chicago Fire of 1871 and San Francisco earthquake and fire of 1906 contributing to the Panics of 1873 and 1907, respectively, we can say the costs of rebuilding the Gulf Coast in general and New Orleans in particular will weigh on the integrity of the banking system. The Federal Reserve, which was born out of the Panic of 1907, knows its first responsibility is to be a lender of last resort to the nation's banks.

The market concluded last week that the Federal Reserve would reverse course, ease, and worry about the consequences later. Katrina is a disaster of the first order, and as the military adage goes, no battle plans ever survive contact with the enemy. If the Federal Reserve pretends nothing changed last week, it risks a credit crunch. If it eases, we can expect a continuation of the rising inflationary expectations, falling dollar, higher credit spreads and steeper yield curve we saw last week. The ultimate course for the stock market will be determined by these other variables and by an ongoing assessment of Katrina's total damage.

Alan Greenspan had only five months left in his term, and may have been perfectly content to keep the rate hikes on autopilot and accept his valedictories. This final component of his legacy may be his most important.