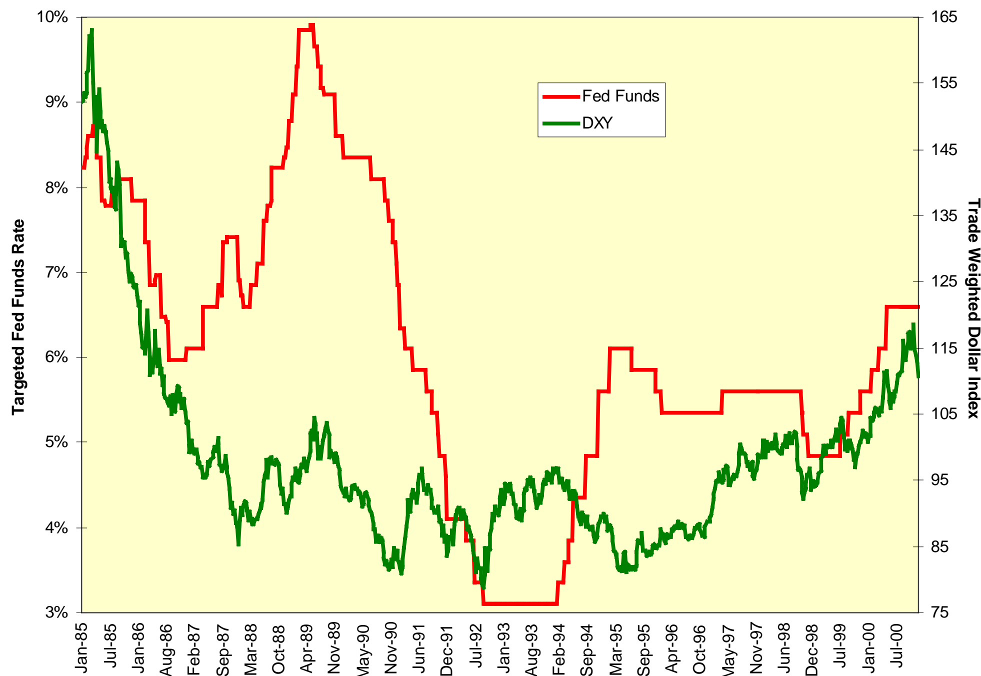
The Outcome of Rate Cuts

Let's hope future historians look back on our age with sorrow and pity. Here we are in a society of (we're told) laws and institutions with free markets for free men, and how do we spend our waking hours? Waiting on and speculating about the decisions of an un-elected group, the Federal Open Market Committee, meeting in secret and debating whether they should adjust the level of free reserves among member banks so as to change the interest rate those banks charge each other for overnight funds.

It's all quite simply amazing: No one, but no one, can forecast the deterministic outcome of these decisions, which are known to operate with long and variable lags. This, of course, is a fancy way of saying we don't know what's going to happen or when. More important, no one makes capital budgeting decisions on the overnight rate. Both the yield curve and the currency markets can either amplify or negate the Fed's intentions, and yet it is indisputable that monetary policy matters.

As we head into a rate reduction cycle, let's look back at the effects of previous rate cutting episodes on the dollar, on interest rates and inflationary expectations, and, of course, on equity prices.

Passing The Buck: Fed Policy And The Dollar

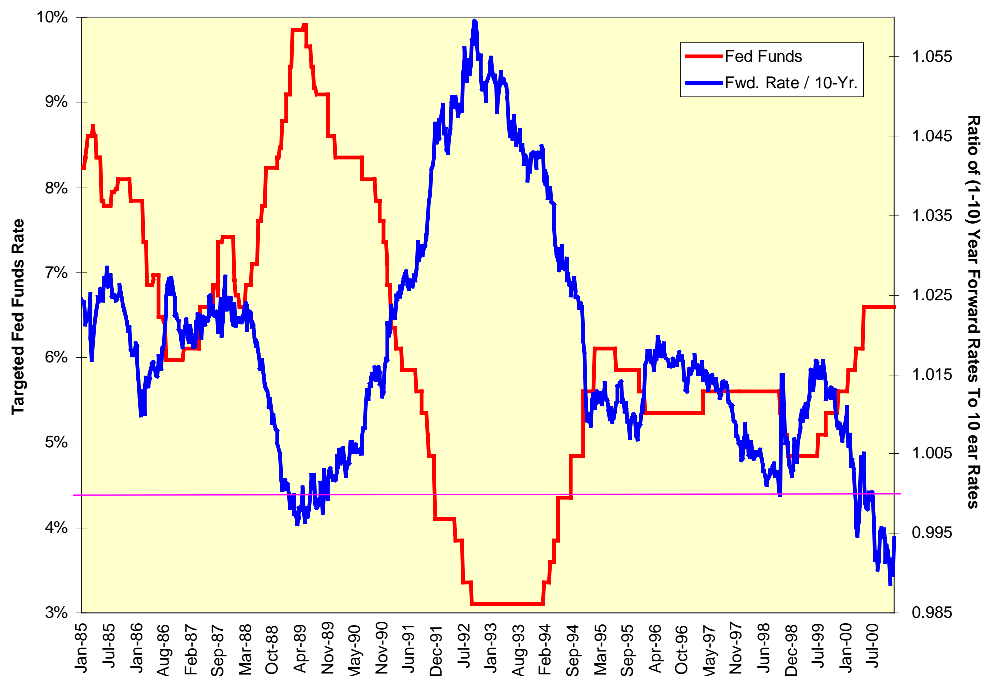


Let's start with the dollar, since its exchange value has ramifications for all sectors of the economy and for the willingness of foreign investors to purchase U.S. financial instruments. The 1985-1986 rate cuts helped drive the dollar down. This decline got out of hand by 1987 as the currency market came to believe the U.S. had a weak dollar policy in response to our growing trade deficit. This fear lingered well into the 1988-1989 tightening cycle. As a result, the greenback did not weaken much between 1989 and 1992 with the prominent exception of the Persian Gulf War downturn as the Fed drove down short-term rates in an attempt to jumpstart the economy.

However, the dollar began to rally in mid-1995, as fed funds remained high relative to interest rates elsewhere. This rally continued through the end of 2000 in a near-parallel fashion to the increase in the funds rate. Given the massive U.S. trade deficit and weakening economic outlook, situations that obtained during the two previous rate cutting cycles, we should expect a downturn in the dollar.

Interest Rates And Inflationary Expectations

Inflation is too much money chasing too few goods. It stands to reason, therefore, a Fed policy of driving down interest rates through an increase in bank reserves should increase inflationary fears. This action should steepen the yield curve – decrease short-term rates relative to long-term rates – and increase forward rates, the rates for borrowing or lending in the future we can secure today. For example, the forward rate between one and ten years is the rate at which we could borrow starting one year from now for the next nine years. If this rate is greater than the ten-year rate, inflationary expectations are rising, and it is a poor time to buy bonds: Note the large peak in this measure in the spring of 1993. Conversely, the prolonged period this measure was under 1.00 in 1989 preceded a bond rally of nearly four years duration. At present, a strong buy signal for bonds again is being flashed.



The Implications For Equities

Rate cuts by themselves are not a magic bullet for equities, as our Japanese friends would attest, but until inflationary expectations start to accelerate, increased liquidity always has a positive contribution to the stock market outlook. The reason is simple: It is far cheaper and simpler to buy a financial claim on productive assets than it is to build and maintain those assets. So, extra money finds its way into financial markets before it finds its way into the real economy. Of course, this is a *partial* effect. Without reasonable expectations for solid growth in earnings and/or falling long-term interest rates, the Fed could pour money on the floor and have little to show for their efforts.

While the relationship between Fed policy and both the dollar and bonds is reasonably direct and causal, the relationship to equities is more complex. Many times the market rallies strongly during the early stages of a Fed tightening, as it did during the first half of 1987 and the October 1999 - March 2000 period, but other times it struggles mightily, as it did during 1994. Sometimes the market rallies explosively during a Fed easing, as it did during late 1985 and early 1986, but sometimes it struggles: Between April 1989 and September 1992, the S&P 500 only advanced at a steady, unspectacular annualized rate of 14.5%.

As expressed here before, the recovery from 2000 is not going to be quick. We need to repair the damage of wide credit spreads, the economic frictions of the tech wreck, the disruptions from high energy prices, and all of the other sand that's been kicked into the gearbox. If the Fed rate cuts operate through the dollar

and through lower bond yields, those will take time to rattle through the economy and improve earnings. Moreover, these changes will produce winners and losers, and it will take time for us to identify who is who and get on the right side of the market. But so be it: This is what free markets are about, and there's no better reason on earth to be optimistic as we enter the new millennium.