

Not Cutting Rates Best Thing for Markets

I'VE TAKEN A lot of heat from readers for staying bullish during the current credit crisis, but I stand on the evidence. It's been a rocky ride, but my calls in the column to buy on dips during this panic have paid off.

Stocks are recovering. As of this writing the S&P 500 is less than 6% off all-time historic highs. For all the fear and loathing, the reality is that this whole episode has barely even been a correction. The bull market lives.

It's hard to find any fellow bulls out there anymore. And oddly enough, those few that I encounter all base their bull case on something I totally disagree with. They think that the Fed is going to save the markets by slashing interest rates. I disagree. I don't think the Fed will cut interest rates at all.

And believe it or not, that will be the best thing for the markets.

First, let's talk about why the Fed won't cut rates. And going in, I admit that virtually everyone expects them to, and the fixed income futures markets are clearly priced for several cuts. I'm practically alone on this.

The reason the Fed won't cut rates is that it doesn't need to. Fed Chairman Ben Bernanke explained it all in a speech in 2002. Bernanke believes that interest rates are the instrument to use to control inflation and regulate growth. Those things aren't the problem today. The problem today is financial market instability.

Bernanke believes that the Fed has a whole different set of tools to deal with financial instability. And interest rate cuts aren't one of them. Instead, the Fed has the power to act as the "lender of last resort" through its so-called discount lending operations. The fed-funds rate governs the rate at which banks lend to each other. But discount operations are when a bank borrows directly from the Fed. That happens when a bank is in real distress and has nowhere else to turn.

Two weeks ago the Fed announced it was cutting the interest rate on its discount operations, not on interest rates generally. Further, it announced very liberal terms for discount loans — including accepting as collateral the kinds of exotic and illiquid mortgage-backed securities that have been the hardest hit in this credit crisis. In short, the Fed was saying: If you get in any trouble at all, we'll be there.

Amazingly, for all the talk about a credit crisis, there has been very little discount borrowing. Four large (and healthy) banks each took \$500 million loans, but that was mostly for show — an orchestrated effort at the Fed's behest just to show the market that the mechanism was in place.

At the same time, the Fed has been injecting many billions of liquidity into the market on an almost daily basis through its regular open market operations — at the existing rate of 5.25%. There doesn't seem to be any need to lower rates, because there is so much demand for liquidity at today's rate.

Further, so far there is no evidence that the credit crisis has had any effect on economic growth. Sure, it's a risk. But the Fed isn't going to cut interest rates just on a risk. As Bernanke said in his highly anticipated speech this morning, he's going to want to see some real evidence. He's watching nervously to be sure, but he's waiting and watching.

For me, the evidence is going the other way. As I said before, stocks are less than 6% off all-time highs. That's not exactly what stocks do when a recession is coming. In fact, it's not even what stocks do in real credit crises. By this stage in the credit crisis of 1998, stocks were down almost 20%.

And forward earnings for the S&P 500 — the consensus estimate for earnings one year from today — is at all-time highs, even higher than when stocks were at all-time highs last month. If a recession were coming, forward earnings would be collapsing.

So grant me that the Fed isn't going to cut rates. Won't that be a disaster for stocks? Isn't everyone on CNBC always saying that stocks are counting on a Fed bailout?

Well, no! The reason the Fed won't cut rates is that it doesn't need to, because there's no recession on the horizon. And if there's no recession on the horizon, and if earnings are booming, then why would stocks care whether or not the Fed cuts rates?

Six weeks ago, stocks were at all-time highs, and no one in the market expected the Fed to cut rates. Now stocks are off about 6%, and everyone expects the Fed to cut rates. Fine — but how can people say that stocks will perform better when the Fed cuts rates? From what I can see, the more people expect the Fed to cut rates, the worse stocks perform.

In fact, I did a study looking day by day at how the market has moved over the last six weeks, compared to how Fed rate cut expectations have moved. What do you know? Whenever expectations for rate cuts flared up, stocks went down. When rate cut expectations diminished, stocks went up.

So why do people say that stocks will rally when there's a rate cut, and that they'll implode if there is no cut? Based on the evidence, it's exactly the opposite. The truth is that nothing would make the stock market happier than for there to be no need for a rate cut in the first place.

And that's just the situation we're in. There will be no rate cut. And stocks will be at new all-time highs by the end of the year.

You heard it here first!


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