Bank Financial Group

TD Economics

Special Report

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US: FED FLAILINGS REVEAL FURTHER NEED FOR CUTS

Summary

-We now forecast 100bp of easing from the Fed tomorrow. At the following two meetings, we look for a further 75bp and then 50bp of easing. This will leave the fed funds rate at an astonishing floor of just 0.75%. This differs from our prior forecast, which had been for a floor of 2.00%.

-Motivating our change of heart, it feels as though the world has been put into overdrive. Negative market developments are now spewing forth not just at an accelerated pace, but it appears that the activity doesn't even stop on weekends.

-The past weekend brought several massive developments. The Fed cut the discount rate, it added another new liquidity facility called the Primary Dealer Credit Facility (PDCF), and JP Morgan bought Bear Stearns. The Fed is clearly flailing around, doing whatever it can to avert an even bigger meltdown than has already occurred.

Discount Rate

-The Fed cut the discount rate by 25bp, bringing the discount rate to just 25bp above the fed funds rate. Although the discount rate has been somewhat of the Fed's neglected child in recent months as other alternatives were introduced to much fanfare, including the TAF and the TSLF, it clearly retains some relevance.

-It is telling that a discount rate cut was made just two days before the proper Fed decision date. This suggests a considerable degree of urgency to the matter: the Fed simply could not wait until Tuesday to do this. When two days are make-or-break for the market, you know that things are extremely serious.

-It is frankly a little frightening that the discount window — despite its stigma — has been forced back into play at a time when the Fed is already injecting hundreds of billions of dollars in liquidity via multiple alternatives (the TAF for depository institutions and the TSLF for primary dealers). It could be that the discount window is expected to act as somewhat of a stop-gap mechanism until the TSLF actually begins on Mar 27.

-But there is reason to think that this discount window change was made with an eye towards getting it back into the spotlight as a key part of the Fed's liquidity injections. This is because the regulations surrounding the program have been made more favourable. Just as the Fed extended the maximum maturity for discount rate loans from overnight to 30 days at the start of the credit crunch last fall, the term has now been extended once again — this time to 90 days from 30 days. This change works to push liquidity up the yield curve to areas that were heretofore quite illiquid, and also helps to add certainty for banking institutions, who can now feel comfortable in the knowledge that they have liquidity for another 90 days instead of just 30 days.

Primary Dealer Credit Facility

-The alphabet soup of liquidity injections just became a little more complicated yet. Added to the pre-existing discount window, TAF, and TSLF facilities, there is now a new kid on the block. It is called the Primary Dealer Credit Facility (PDCF), and was unanimously approved by the Fed yesterday.

-The PDCF is limited to primary dealers, who seem to be the most adversely affected institutions at present. The program is effective immediately (today: Mar 17), and will last at least six months. At its essence, this program extends what can be called "discount window-lite" to the primary dealers. Although the liquidity is only available overnight (renewable for up to 120 business days), the main advantage of the PDCF is that it allows for a remarkably broad range of collateral in exchange for cash for the primary dealers. Indeed, although the collateral must be in-

vestment grade, the set of available collateral products now include all investment-grade corporate securities, municipal securities, mortgage-backed securities, and asset-backed securities for which a price is available.

-The new PDCF will be transacted at the newly lowered discount rate. There appears to be no explicit limit to the amount of lending available through this program, much as there is no limit to the size of the discount window. The PDCF appears to be somewhat secretive, akin to the discount window, and the only way to know how much borrowing is occurring will be to look at the weekly Fed credit outstanding as per the regularly Federal Reserve Statistical Release H.4.1.

-There should not be any inflationary implication that comes from this new program. Although a great deal of cash will be injected into the market where it is urgently needed, the Fed plans to sterilize this action by withdrawing cash elsewhere via the possible sale of Treasury securities.

Bear Stearns

-We are not financial analysts, and so cannot speak on the subject of Bear Stearns with a great deal of authority.

-The fact that Bear Stearns was acquired by JP Morgan for just $2/share indicates the severity of the problem at Bear Stearns. If we are to believe the market stories, Bear Stearns may have been felled by a rather unfortunate game of telephone insofar as it was actually functioning at a reasonable efficiency until market whispers conspired to encourage other market participants to shun the bank.

-In an environment such as this, it is not inconceivable that other banks will be crunched in much the same fashion. One already hears vague rumours of another bank being treated similarly, with all of the resultant risks. We take some solace in the notion that it is virtually impossible for a major U.S. bank to truly fail — bailouts are inevitable given that one failure could quite literally take the entire U.S. financial system down given counterparty exposure.

The Fed Tomorrow

-The obvious next question for the U.S. market is how much the Fed will cut on Tuesday. Understandably, the outlook has become considerably more pessimistic in recent days as banks fail, the Fed flails, and the seriousness of the situation sinks in. Reflecting this, our own view is now that the Fed will cut by 100bp tomorrow. This is a bold move, but given that the situation now looks more severe than it did in late January, we think it is justifiable that the Fed will move in such a large increment. The worst-case scenario of a complete banking meltdown appears frighteningly near to reality.

-The traditional toolkit used to evaluate central bank easing has to be thrown out the window when looking at situations such as this one. Fed actions now have a significant psychological component, and rigorous approaches like the Taylor rule and other model-based approaches are no longer especially relevant. The fed funds rate needs to be quite low to avoid moral collapse, and the issue of how to get the fed funds rate back up to quasi-normal levels can be worried about at a later date (though it is likely to occur somewhat more sharply than in the last cycle, whenever it does happen).

-Could the Fed cut the fed funds rate today — the day before its scheduled meeting? Nothing is impossible right now. If market conditions continue to deteriorate as they currently are, one could not rule out a move today and another move tomorrow. This one feels like a stretch, but stranger things have happened.

-Could the discount rate spread be cut further? Nothing is impossible. At this point, it is entirely possible that the discount rate could be cut to below the fed funds rate, much as it traditionally was until a few years ago. This would certainly be a peculiar situation insofar as it would then be cheaper to borrow from a safe entity (the Fed) than from riskier ones (other banks). But it is not unprecedented. Still, we assume that the discount rate continues to operate 25bp above the fed funds rate tomorrow as it does not make sense to cut the discount rate spread by 25bp two days before the meeting and then to go again at the meeting. Far easier to make the move in one fell swoop. But risks remain for further moves down the road.

The Fed Later

-As we look beyond the next Fed decision tomorrow, we feel that the fed funds rate will ultimately go to just 0.75% over the following two meetings, via a 75bp and then a 50bp cut. To be clear, that first number is the level, not the amount of anticipated easing. In turn, this would place the fed funds rate even lower than the 1.00% reached in the last cycle. In justification of this bold call, it now appears that the current situation is worse in virtually every way than it was in 2001-2003.

-It has becoming increasingly clear that the traditional concerns of a central bank have been thrown out the window and replaced with panic mode. Yes, it would be nice to

keep the powder dry for future cuts. Yes, there is perhaps a risk of inflation when easing is so sharp. But these concerns are secondary. What better place to cut than now when banks are seriously at risk and the market is in full flight panic mode, ala late January when the Fed cut by a total of 125bp? And can inflation really exist in an environment in which the money supply is at risk of shrinking courtesy of a declining stock market, falling home prices, a recessionary economy, and monetary policy easing that is not even reaching the average person (instead, it is lodged in the financial sector, which is perhaps not such a bad thing, all things considered)? The latest PDCF program shouldn't even be inflationary as the Fed plans to sterilize it.

-Given the way things are going, it would also feel foolish to rule out the possibility of other types of liquidity injections from the Fed over the next few days and weeks. As we see it, there are four main dimensions along which liquidity injections can be enhanced. These are the duration of the loans, the size of the loans, the safety of the collateral, and availability. If the recent trend remains in place, some or all of these factors could be enhanced further.

-The duration of available lending could be pushed out beyond the 90 days now available at the discount window. This is especially true for the now PDCF program, which remains inferior to the discount window insofar as the PDCF is only good for overnight lending whereas the discount window now goes up to 90 days.

-The size of the lending could be bumped up further for the TAF and TSLF, and there is already no technical limit on lending via the discount window or the PDCF.

-The type of collateral available for use has already been pushed out considerably, and now extends all the way to investment-grade mortgage-backed securities. It is theoretically possible that lower quality collateral might be permitted, though this would expose the Fed to serious risk.

-Availability could also be enhanced. Some programs (ie TAF and PDCF) only reach primary dealers, others only reach depository institutions (ie discount window and TSLF). Although some entities are both depository institutions and primary dealers, some are only one or the other. Although there is a great deal of overlap across the two sets of programs, it is possible that some of these programs could be opened up to both sets in the future. More likely is that the TAF/TSLF and discount window/PDCF will continue to be enhanced in a roughly similar fashion while maintaining a different customer-base.

-The U.S. federal government could get involved. Along the lines of our view that bailouts are inevitable (if needed), it may simply be unreasonable for private institutions and the Fed to do all of the bailing out. It is quite possible that the federal government will have to explicitly step in as well, perhaps along the lines of the Resolution Trust Corporation used to address the Savings and Loan Crisis.

Bond Market Stance

-Even with the recently announced Fed action, the Bear Stearns takeover, and market expectations for 100bp+ of easing tomorrow, market credit conditions continue to deteriorate, and in some cases, seize up.

-Although it is always darkest before the light, we are increasingly of the mind that this storm is not yet over. Short duration plays and flatteners in the bond market likely remain too early. There is plenty of pain left to be felt, be it further bank crumblings, hedge fund unwinds, bond insurer downgrades, or some other still hazy bogeyman.

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