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Rate Cuts May Not End As Soon As Wall Street Thinks

RATE CUTS MAY NOT END AS SOON AS WALL STREET THINKSSenior Features Editor
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There are few things more dangerous on Wall Street than the combination of overwhelming consensus and unbridled optimism. But that seems to be the case with how the Street was viewing the Fed's next move on interest rates and what it says about the credit crunch and the economy.

Six weeks after most were clamoring for the Fed to cut interest rates by a full percentage point, the consensus was that the central bank would cut rates a mere quarter of a point at the conclusion of its two-day meeting Wenesday and likely signal the end of its easing campaign.

The consensus was right, as the Fed did takes rates to 2.00 percent, but the 360 in psychology is nevertheless striking.

"It's the ultimate herd mentality," says Scott Rothbort, president of LakeView Asset Management and a professor at Seton Hall University's graduate school of business. "There's a decent chance that they're done but I wouldn't bet on it."

It Ain't Over 'Till...

Rothbort falls somewhere between the consensus view--which says the worst of the credit crunch appears to be over and the recession is mild, if non-existent--and the rare contrarian one, which says the weak economy is now the Fed's biggest worry.

Nariman Behravesh, chief economist at Global Insight, is one of the contrarians.

"The news on the economy is going to be pretty much unrelentingly bad in the next few months," says Behravesh, who adds there's good chance the Fed will cut rates again at its June meeting -- something few other economists are forecasting.

Behravesh isn't forecasting much, if any, recovery in the housing market until 2009 and expects escalating job losses.

Payrolls have been declining since late 2008, but have yet to exceed 100,000 a month. April data due out Friday is expected to show a loss of 75,000 jobs, according to Briefing.com.

In the eight-month recession of 2001, payrolls fell an average of 180,000 says Robert Brusca, chief economist at Fact & Opinion Economics, who notes that layoffs tend to rise sharply after the first few months of a recession.

"You can imagine how severe they'll have to be to match that," says Brusca, adding. "Housing will have a hard time turning around if the job market goes bad."

As usual, there are a lot of "ifs" in the debate and various scenarios, but even veteran opinion shapers like PIMCO's Bill Gross are skeptical about the return of happy days to Wall Street.

Happy Daze

In a note to clients Tuesday, Gross said the "euphoric" rebound in stocks and non-government bonds may be premature, given the slumping housing market's potential impact on the economy and financial markets.

That euphoria, however, appears to be a key factor for the consensus view on the Fed. Stocks recently touched their highest levels since early January. The Fed-engineered rescue of **Bear Stearns** and its related-decision in March to allow commercial banks to borrow through its discount window are widely considered key moves in stemming the credit crunch that was destabilizing financial markets.

That change in market psychology is a "testament to the Fed's effectiveness, " says David Jones, president of DMJ Advisors, who expects the Fed to take the federal funds rate to 2.00 percent and stop there.

That improvement could be fleeting, if there's another unpleasant surprise on the credit crunch front, which is hardly improbable.

"I don't think Wall Street is completely over that," says Behravesh. "There's likely to be more big headlines. Either that or a long string of bad numbers on the economy."

"If the economy takes another leg down, we'll probably see the Fed ease some more," adds Brusca.

Bernanke's most recent comments to Congress as well as the FOMC's March statement show little reason for immediate optimism.

"The outlook for economic activity has weakened further … and the deepening of the housing contraction are likely to weigh on economic growth over the next few quarters," states the FOMC.

No optimism there. That's not to say the contrarian view is a fundamentally pessimistic one. It's more a matter of precaution.

Virtually all agree that the Fed's aggressive rate cutting is over, but that's very different that calling a bottom. After all, the central bank did take rates as low as 1.00 percent in 2003 and kept them there for a year.

Downside of Rate Cuts

The biggest arguments for a pause, if not an end, to rate cutting, in the dominant consensus view are growing concerns that the Fed may be stoking inflationary expectations and the somewhat related weak dollar/high oil prices nexus – neither of which are a drag on stock prices these days

It's true that a quarter point cut in the funds rate to 2.00 percent makes for negative real interest rates with the core PCE index currently sporting a 2.20 percent year-over-year gain. (The government updates that data May 1.) But the central bank has allowed that to happen before during a recession--and the Bernanke Fed has already indicated its prepared to do so.

There's also eason to believe the dollar has already bottomed; it's now roughly where it was against the Euro ahead of the big March rate cut.

And for all the talk that speculation is a big part of the crude oil bubble, there are those who insist prices largely reflect supply-and-demand dynamics.

If that's the case, then neither oil nor the dollar will be much affected by further rate cuts.

That leaves the potential impact of the government's $168 billion fiscal stimulus plan, whose tax rebates are just now starting to reach consumers. A good part of that disposable income will very likely be spent on gasoline and food. Pessimistic consumers will save as much of the rest as possible.

That gives the Fed something new to think about and "monitor," as the FOMC is wont to say, which makes for more uncertainty starting with its June meeting.

“There’s still a bias toward easing at the next two meetings,” former Fed governor Laurence Meyer told CNBC. “The Fed has not moved recklessly toward accommodation. There's a presumption there's going to a rate pause next time unless something really pushes them off their course.

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