ECONOMIC COMMENTARY

With the market set to drop 1000 points, the Fed cuts interest rates 75bp, and 50bp more to come this week

Latest Developments

The week's data was weaker for the second week in a row, but that is misleading as only one economic report was available, existing home sales, and they were down.

We expect the Fed to cut rates yet again this week by 50bp as GDP will come in soft at 1.5% or worse and employment will be under 100k.

Dow, a roller coaster ride for the week

Tuesday opens down -450 points and would have been much worse if not for the Fed, then rose 300.

Wednesday down 300 matching the low of Monday, then an amazing 600 point rally.

Thursday, up 100.

Friday, up 100 again, but then down 270 erasing the early gains of Friday and the entire day of Thursday. (chart on right)

As I've been saying for some time, this is a market that doesn't know which direction to go, such amazing one days swings simply aren't normal in either direction and to have them day after day... Well at least the volatility traders are happy.

Looks like a tax rebate is on the way

This is early so it isn't clear if this counts as an early return on 2007 taxes or 2008 taxes, but either way it's not a good idea. This will neither stimulate the economy beyond a few week blip, nor solve what is wrong with the economy. But politicians need to appear top of the problem, so we get this window dressing. The last time we got a rebate about 20% was spent and the majority was used to retired existing debt.

Over the last 5 years, the consumer has spent every last penny they earned, every last penny they planned to save, have taken savings out of the bank to spend, and have spent nearly all the built up equity in their homes. Politicians think a few hundred dollars more will get consumers to spend and rescue the economy? It's baffling. Consumers are pulling back on discretionary spending, because they can't tap out the house anymore, they have to start saving again, mortgage payments are rising, food prices are rising, and employment growth is sputtering. A few hundred dollars more won't dent those headwinds.

WEEK'S DATA WAS WEAKER THAN EXPECTED

The tax breaks for business are a little better, personally I'm in favor of zero taxes on business, but lowering the cost of business equipment doesn't get to the underlying problems businesses are facing. Which of course is a tough lending environment, billions of bad loans, bad investments, rising prices and falling profit margins, and an exhausted consumer who in the end purchases 70% of the output of this country. (related WSJ article with the details of the bill on the blog)

Existing home sales

The consensus had expected 4.95 million existing home sales, but actual home sales were lower down 2.2% to 4.89 million with sales slumping in ever region but the largest decline in the northeast. Prices were only down fractionally compared to last month, but the year over year comparison just broke an all time record.

The inflation adjusted 6 month moving average of existing home prices is now down 6% the greatest home price drop since records have been maintained going back to 1966.

The nominal (not adjusted for inflation) record for price declines was already set last year, and it's been steadily falling since then.

However there is some good news. There continues to be a reduction in homes for sale inventory. Homes for sale fell from 4.2 million to 3.9 million reducing the month's supply

The Dow Jones 30: Monday was closed due to the MLK Jr. holiday but fell 7% around the world. Tuesday had a 450 drop during the day and Wednesday included a 600 point rally.

from 10.1 to 9.6. (chart on blog)

It's not 1987 all over again

In the crash of 1987 the economy was fundamentally sound. By cutting interest rates the Fed was able to come to the rescue of the financial sector. Yesterday's charge into the markets did that yet again, we saw financial stocks rise, but the fundamentals this time around are completely different. The economy is sinking into a recession, the world is slowing down, and forward looking earnings are too optimistic and continue to be revised down.

On the blog we tracked "what" was happening, today I'll discuss its appropriateness. In short should the Fed attempt to save the stock market? My answer is no, if someone swallows poison and is throwing up, don't stop them, wait until the poison is completely removed until you step in to begin treatment. Tuesday's action makes the Fed appear more worried about the vomiting then the poison.

I wondered what would happen if the Fed did step in and the market shrugged it off, well that is exactly where we appear to be. The patient is again getting ill, and no wonder, the problems still remain.

Foreign markets are all down today (Tuesday) around 4%, and the futures markets suggest a bad day is ahead of us here in the U.S. And all of this is during 3 days of zero economic news, only 1 report is issued this entire week. Just wait until next week when the markets are reminded the U.S. is in a recession.

The painful fact is the U.S. has to unwind from a tremendous bubble, years in the making, and the Fed should allow the free market to be just that, free and able to find its true valuation. So provide liquidity, and lower the discount rate, massively step up oversight in the financial sector, but remain on a slow glide path down with interest rates. Let's remember the last time the Fed massively cut interest rates from 6.5% to 1% in 12 months time, it just moved the poison from the stock market to the housing market.

Market corrections are never orderly and if the Fed attempts to backstop the market it creates an opening for moral hazard (and inflation) to enter, the Fed was never created to ensure investors don't lose money, it's mandate has always been first to fight inflation, and second to attempt full employment.

Besides, the Fed can only give us 4 more 75bp shots.

Fed cut rates 75bp

The foreign markets had opened and were dropping this morning (Tuesday) to even greater losses. Absent that I had thought we'd maybe wake up to a 50bp cut this morning, but instead we get 75bp! This is the first time the Fed has made an emergency rate cut outside of the FOMC meetings since the last recession. The Fed really wants to stem the losses it expects today.

Dow set to lose 1000 points tomorrow

Stocks all around the world are falling by 8% for Monday, the only good news is that our stock market is closed today. A 8% drop here at home is about a 1000 point loss for the Dow.

In an earlier post (see video on blog) Jim Cramer is on record forecasting a 2000 point drop due to the lock up in the insurance industry, others are taking about the evaporation of the jumbo mortgage loan market. As no one is willing to purchase any home loans above the Fannie / Freddie limits.

The 2 year T bond is at 3.25% (at 1.88% less than 48 hours later) as the bond market is expecting the Fed to cut rates by 50bp, but many think if the Dow slips by 500 points let alone 1000, then the Fed will cut by 50bp sometime tomorrow in a rare intra-meeting move.

So what happens if we do get a 1000 point day? With the Dow at 11,000 a market bottom looks awfully close to reality.

Again the saving grace is the U.S. markets are closed today, this gives us two advantages. First the policy makers can start thinking about their response, and second, if the foreign markets rebound tomorrow that will reassure traders here at home before our markets open.

The Fiscal rescue plan is worthless

(video clip of Chris Matthews and Jim Cramer on blog)

Things I agree with Cramer in this video:

1. Fiscal Stimulus package from the government won't help the economy and is only window dressing to give the appearance they are doing something.

2. Something must be done with the major insurance companies which no one is talking about, if not a 2000 point drop in the Dow will happen.

3. We are on course for a massive Democratic sweep into office ala 1994 but the other direction. (59% to 41% turnout so far in 4 states)

4. We are in a bear market

5. Recession started in Dec ‘07.

6. Is there a floor on the market? Yes. Interest rates are so low, you're better off buying a Dow stock with a dividend yield of better than 1.9% instead. (last week why I see a silver lining if a big stock market correction)

I don't always agree with Jim, he was spectacularly wrong on housing on July 16th when he made fun of people (like me) making a big deal about housing, but he finally got on board and turned completely around just a few weeks later on August 6th. Although an apology for the July 16th rant is still missing.

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