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Paper cuts

Fed must further cut the discount rate

SUMMING IT UP

William Rutherford

The stock market got through August with the Dow Jones industrial average up 1.1 percent, but not before a wild, volatile ride, with 14 triple-digit moves in the 23-trading-day month.

The performance easily bested the 12 triple-digit moves of August 2002. This August, the Dow reached a high of 13,600 and plumbed a low of 12,900, but it ended about where it started. Although August has a reputation for being a difficult month, we survived it and now move into September, another historically difficult month.

The reasons for the volatility were, of course, the problems in the housing market and the subprime loan debacle. Lenders re-rated risk, and the price of paper, whether mortgages or commercial paper, was cut.

As the subprime problem spread to other sectors of the mortgage market and then to the commercial paper market, creditworthy borrowers were hurt. Fears of a recession grew. Calls for the Federal Reserve to take action intensified. Housing prices were affected, too. The question was, Will the difficulties in the financial markets spread to the "real economy"?

Seeds for the mortgage problems were sewn years ago, under the Greenspan administration, when interest rates remained at historically low levels for a long period of time. During that time, Greenspan, worried about deflation, and schilling for adjustable-rate mortgages, encouraged home borrowers to "take advantage" of the adjustable rates, marking the first time a Federal Reserve chairman had involved himself in the selling of home loans. Subprime borrowers and homeowners, many of them new, began to take advantage of the low rates.

Even after other Fed governors urged caution and suggested more regulation of subprime borrowing, Greenspan rejected that notion and stoked the mortgage market further. Homeowners and would-be-homeowners, some without adequate credit, bought into the housing market and loaded up with debt they would not be able to repay.

Foreclosures just start of the problem

About 2 million homeowners will see their mortgages reset to higher rates in the months ahead. Foreclosure rates have already soared and are expected to go much higher. Entire neighborhoods and towns have already been blighted by the foreclosures; many more are expected to follow.

Not surprisingly, housing prices have fallen dramatically. A further fall in home prices is expected, and the insidious nature of the tax laws decrees that people who lose their homes have taxable income because their debts have been forgiven – debts they of course cannot pay.

Various funds, holding subprime loans sponsored by luminaries like Goldman Sachs, Lehman Brothers and Bear Stearns, have required capital infusions of billions yet still face problems. The problem has gone worldwide, as two German banks are near failure because of their investment in subprime loans, and banks in England, and even in China, have suffered. As I reported in my July 9 column, "The ghost of Greenspan past," perhaps the biggest problem is that no one knows how big the problem is.

Problems once isolated to the housing industry could spoil the whole economy if the Fed isn't proactive

For the Fed, the first order of business was to limit the problem to the financial markets. Few cared if a few speculators got burned; the problem spilling over to the rest of the economy was another matter. The problem gave every indication of spilling over.

The Federal Reserve took some action to contain the problem. Just six days after meeting and not even discussing interest rates, the Fed was forced to act, cutting the discount rate 50 basis points and declaring the discount window open. When borrowers didn't show up, arms were twisted and banks borrowed. In Europe the experience was different: The Central Bank was very

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aggressive in pouring money into the system, and banks were not reluctant to borrow. Bank of America scored some points by coming to the rescue of Countrywide, which had been rumored to be facing bankruptcy, with a $2 billion cash infusion in return for a large piece of the company. The Countrywide CEO immediately forecast a recession for the U.S. economy.

Problem can't be ignored

The president, much later, came forth with a modest proposal that would benefit very few homeowners, demonstrating lack of understanding of the scope of the problem and perhaps setting the stage for his second Katrina.

The debate began between those who wanted to hold the line for fiscal discipline and let the "greedy speculators" suffer, and those who thought the government should act to forestall almost certain financial disaster. At the nub was the so called "Greenspan put," the notion that, if the markets faltered, the Federal Reserve would ride to the rescue. The "put" is criticized because if the Fed can always be counted on to rescue the markets, there will be no critical evaluation of risk, and the markets will just act to excess repeatedly, setting up a vicious cycle of bad behavior. It is sometimes called "a moral hazard."

The trouble is that if the problem is real and ignored, it will get the best of the economy. We are already seeing a breaching of the dike between the financial markets and the real economy, as jobless claims are rising, consumer confidence has declined and auto sales are forecast to fall. Still, the government reports the GDP for the last quarter was a robust 4 percent when it was expected to be 2.5 percent.

Difficult options only hope of fix

All this presents Fed Chairman Ben Bernanke with another difficult choice as he cleans up yet another problem bequeathed by his predecessor. He has some room to maneuver: Inflation, as measured by the Fed, is in check. He all but told the markets he will cut rates Sept. 18 when he said the Fed "would act as needed." Still, he said bailing out investors was not the Fed's responsibility, and indeed it is not, so although he may not want to act, he may have no choice, because the other responsibility of the Fed is to protect the economy and let it grow at its natural rate. If he fails to act, he may find himself in the same place as his predecessor, looking at his historical data, ignoring where the economy is going, and driving over a cliff while looking in the rearview mirror. Probably he does not want to be a day late and a dollar short, as Greenspan was known to be.

With home foreclosures reaching record levels, the odds of a recession are rising, but I still don't think we need to have one – if the Fed acts proactively.

The Fed needs to cut rates at its Sept 18 meeting. But the governors don't want to cut rates, so they probably will cut only 25 basis points. That cut will be symbolic and not enough, and they'll have to cut again. They don't want to do an inter-meeting cut because that will only emphasize the problem. In addition, they could, and should, further cut the discount rate and add additional liquidity to the system. Aggressive action will help the commercial credit market as well as the economy generally. Anything less will cause havoc in the markets and raise the risk of recession. These are hard choices, but they have to be made.

William Rutherford is the founder and president of the Portland company Rutherford Investment Management, listed in Barron's as one of the leading separate account managers in the country and recipient of a four-star rating from Morningstar. He is also the author of a critical appraisal of Alan Greenspan's term as Fed chief, "Who Shot Goldilocks?" Contact him at 888-755-6546 or wrutherford@rutherfordinvestment.com.