FX/Global Strategy

RBS Greenwich Capital

Alpha Alert – The case for 50bps; the Fed compromise; the FX reaction.

Sept 11th, 2007

Contact::
Alan Ruskin
203-618-6402
Alan.Ruskin@rbsgc.com

www.rbsmarkets.com

It is one of the closest calls in years. Should the Fed cut by 25bp or 50bps on Sept 18th? Attached is a matrix on the key FOMC discussion points, and how those arguing for 25bps versus 50bps would make their case. **On balance I think it suggests 50bps is preferable, but a conservative Fed, loathe to admit that it has been wrong on risks to the financial and real economy, will prefer to go 25bps, unless in the interim, the market makes it abundantly clear that asset prices will 'tank' on a 25bp move.**

One compromise is that the Fed cuts the funds rate by 25bp, but provides further assistance to the money market with a 50bp cut in the discount rate, and also comes up with a dovish communique hinting at further rate cuts 'if needed'. At this point, I personally think this 'compromise' is the most likely scenario.

How will the market respond to different scenarios. Obviously it depends on how the Fed primes the market before the meeting as to what will be priced in by Sept 18th. As of now, futures/options prices both suggest that a 50bp is more likely than 25bp. By this measure, risky assets will take a tumble on a 25bp cut even with a 50bp discount rate reduction, and the risks of later additional rate cuts will still hurt the USD. A 50bps rate cut would not lead to any expectation that the Fed is now done, and may add to fears on growth prospects, with even more obvious negative USD implications. The USD is then in a classic 'no win' situation. Carry and Risk appetite will probably prove peripheral to the broader USD story, with USD weakness still as much evident versus the Scandis, EUR and CHF, as much as the yen.

So what is saving USD now? There are at least five possibilities – 1) demand for USD remains strong given current liquidity constrained money markets; 2) Four rate cuts are already priced in for early Q2 2008; 3) if US growth starts to slide it will lead to greater contagion elsewhere; 4) the bond rally is sucking in capital inflows; 5) selling USD is 'the obvious trade' Ultimately I suspect the market will keep to basics, and that we are in for a period of additional spread reduction in key bond spreads against the USD, as Fed rate cuts materialize, that will indeed weigh on the USD, even if the above factors slow the USD's path.

Discussion	In favour of 25bps	In favour of 50bps
Small incremental steps do work, or, don't work?	Equities/Credit markets stabilized after 'symbolic' discount rate action.	Markets have only stabilised because they expect more aggressive action on the funds rate. Small steps will not fix rates that matter to the real economy and housing market
Panic or proactive?	To do more than 25bp might signal panic.	50bps would put the Fed 'at or ahead' of the curve.
Lower or higher bond yields?	Don't worry about validating curve, market will push down longer-term rates if Fed perceived as too tight	Important to validate the curve, if current bond yields (or lower) are desired. Fighting lower bond yields was OK in 2006, not now!

Discussion Topics	In favour of 25bps	In favour of 50bps
Rate cuts won't help. – do max or do minimum?	Easing won't help a liquidity crisis, so do the minimum, focus on other areas of liquidity support. 50bp that does not work will hurt Fed's reputation.	Won't help much so do the maximum to have at least some positive real economic impact. Rate cuts help liquidity through multiple indirect mechanisms, including psychology.
Save or spend bullets?	Save bullets for later, when real economic weakness more evident.	Early and aggressive easing in a deflation cycle is important. A bullet today is worth two tomorrow. Psychology will only improve by leapfrogging expectations.
Financial conditions tight or not so tight?	Financial conditions are still not unusually tight. S&P still positive on year.	Financial conditions have tightened appreciably as terms of lending have tightened and credit availability suggests focusing on credit quantity, not price.
Inflation problem or not?	Latent persistent inflation problem. Recent inflation gains are tentative.	Inflation within range and set to dip lower as demand slows. Price expectations slowing.
Consumer in need of help, or not yet?	Await more evidence from the consumer. Only have one mths employment data. Adjustment higher in savings ratio desirable long-term.	No reason to think housing will NOT go through another leg of weakness that with weaker employment hits the consumer hard
Bail-out: Wall St or Main St?	Excessive rate cuts prone to reinforce bubble mentality, and will be seen as a Wall Street bail-out.	The same bubbles are not reflated when popped. Problem has conclusively reached Main Street.
Price of policy mistakes – the least worst policy?	Excessive rate cuts could reinforce 'Helicopter Ben' reputation	Rate cuts that are excessive can be quickly reversed, and that might be a nice problem to have.
Risks of excessive easing	Past easing reignited bubbles, and bubble mentality. This cycle must end!	Post 1998 were not about excessive easing, but not reversing the rate cuts quickly enough. Same holds for 2004/5.
Market response.	Assets markets will take a 25bp as a sign that the Fed maintains an optimistic view	Asset prices will tumble on a 25bp cut, and could force a worse case scenario intra-meeting move.
The US Dollar matters or not?	Dollar weakness undermines inflation outlook should constrain easing. Might undermine bond inflows.	Dollar weakness will be part of a much needed readjustment from domestic toward external demand, and inflation pass-through will remain limited.
Repricing of Risk is desirable or incomplete?	Risk repricing is appropriate; key credit spreads closer to long-term averages.	Risk repricing is incomplete, markets are not clearing and need all the Fed help they can get.
Excessive focus on money market	Too much focus on LIBOR rate. Rate cuts won't fix ABCP market that is driving liquidity problems.	Aggressive rate cut seen as part of a mix of solutions. (Discount rate, system RPS, widening collateral base etc) that will help normalize the money mkt & support economy.

:

[1[1]] ***"Material"*** *means any investment research as defined by FSA contained in (but not limited to) hard copy documents, presentations and presentation materials, web-sites, electronic mail and other forms of electronic communication.*