Economic Commentary

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Greenspan's Inter-meeting Surprise Rate Cut: Cause for Cheer or Worry?

Yesterday, Alan Greenspan surprised markets with an inter-meeting 50 basis point cut in the federal funds rate to 4.5%. This brings rates down by 200 basis points since the beginning of the year, the steepest rate plunge in Greenspan's 14-year tenure and the fourth time since 1994 that he cut rates between meetings, two of which have been this year. What prompted the Federal Reserve to cut rates so suddenly when the next regularly scheduled FOMC meeting is less than a month away on May 15th?

Also yesterday, the Conference Board (CB) in New York reported the latest results for its index of leading economic indicators, which is designed to forecast economic activity over the next three to six months. While the index fell 0.3 per cent in March to 108.5 - the second consecutive monthly decline- the board said the pace of the decline was not deep enough to prompt an economic recession. Meanwhile, the Economic Cycle Research Institute (ECRI) in New York said that its monthly and weekly leading indexes show a recession is "no longer avoidable". The last time ECRI made such a call was in February, 1990, just before the last US recession. ECRI claims that it has correctly called two of the last three recessions. On the other hand the CB has missed the previous two recessions (1990-91 and 1981-82). Which of the two is to be believed?

Suddenly New Economy companies are having trouble financing their activities because underwriting has virtually disappeared. Facing difficulty in raising funds in the equity and debt markets, high technology firms are slashing investment budgets and laying off workers. This is especially worrisome because business investment accounted for 30% of the total growth in the US economy since 1995 and for 75% of the productivity growth that made the US economic performance so spectacular. Left un-helped, the sharp drop in capital investment can bring about a recession.

It appears that Greenspan chose to believe the ECRI forecast and is taking desperate action to forestall the recession. The odds of a recession - although he didn't say so, <u>now exceed 50%</u>.

Clearly then the odds favour a recession and Greenspan is trying at the last minute to avoid the recession. Will the interest rate cuts delivered so far and the additional cuts that are in the pipeline prove timely enough to avert a recession? Greenspan's aggressive rate cutting action will certainly aid the economy and might, just might prove sufficient to avert a recession, but at this point there is no way of knowing for sure. Only time will tell.

My view, enunciated at the last ALCO meeting of February 28th based on an analysis of the inverted yield curve, is that the US economy is most probably in an inevitable course toward a recession, albeit a mild one. So far, the aggressive rate cuts in the USA and Canada support this view. My sense, however, is that the economic slowdown has not yet bottomed and we are in for further weakness and further rate cuts.

The outlook on the Canadian side of the border is decidedly brighter. Although Canada is experiencing a slowdown, I maintain my forecast that we will avoid a recession, as the US goes through one. Rates, however, will have to come down some more in Canada before it is all over. David Dodge is being too complacent and is reacting too cautiously. By choosing to cut Canada's rates by only 25 basis points this Tuesday (April 17th) he is still behind the curve. Unless he opts for a surprise rate cut of his own, it looks like he will have to cut rates by as much as 50 basis points the next time the BOC meets on May 29th and perhaps again on July 17th and August 28th.

The implications for equities are that we have not seen the bottom yet. Despite yesterday's spectacular rally in equity markets, it looks that the market will head lower and test new lows as we head in to summer. Implications for bond prices are that the have yet to peak, so bond yields (especially the 5 - 10 year maturities) should head lower. As far as the Canadian dollar is concerned, I believe we are at, or near the lows we are going to see for now. The US dollar cannot maintain its strength at present levels in the face of declining interest rates and a slowing economy. At this moment US rates are 50 basis points lower than CAD and 25 basis points below the Euro zone. If indeed the fed rate cuts prove unable to prevent the US economy from sliding further into a recession, the next batch of surprising news will be about the US dollar.

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