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LATEST FED INTEREST RATE CUT IS NOT A PANACEA

– CIBC GLOBAL ASSET MANAGEMENT FIXED INCOME TEAM

The U.S. Federal Reserve (the Fed) reduced the Fed funds rate by 75 basis points on March 18, to 2.25%, disappointing some observers who were expecting a full 1% cut. The Fed also reduced the discount rate by the same amount to 2.50%. (The Fed funds rate is the interest rate at which member banks may lend federal funds to one another on an overnight basis. The discount rate is the interest rate the Fed charges on loans to its member banks.)

In its statement, the Fed cited its expectation that the "...tightening of credit conditions and the deepening of the housing contraction are likely to weigh on economic growth over the next few quarters" as rationale for the cut, but they also expressed concern that "...inflation has been elevated and some indicators of inflation expectations have risen". This last statement is an attempt to prepare investors for fewer interest rate cuts in the future.

The Fed has taken this action, along with several unconventional measures over the past couple of weeks, to ensure that the financial system's wheels stay greased. The interest rate cuts are important, but perhaps just as important are unconventional steps, such as the Term Securities Lending Facility and the Primary Dealer Credit Facility, established this month to give the primary dealers access to liquidity. Right now, we can't overstate the importance of maintaining access to liquidity and ensuring confidence.

While the Fed's moves are helpful – and necessary – we believe they are not a panacea for the ills in the financial markets. The amount of leverage, speculation, and poor lending practices that has occurred in the past several years are unprecedented and it will take more time to be unwound. The Fed is buying time and we expect further volatility and evidence of weakness in the economy before the all clear signal can be given.

We expect some further easing of administered rates by the Fed and the Bank of Canada. However, we seem to be close to the end of the easing cycle. We also believe that the rally in government bond yields, which have been the main beneficiary of the concerns in the system, is also closer to the end, but we expect the yield curve to remain steep for some time to come. A steep curve will help repair some of the damage that financial institutions have suffered these past several quarters, but it may not bring a quick resolution to their problems. Investment grade corporate bond spreads – which have tripled in the last year to levels almost never seen before – are now, in our view, at attractive levels. Currently, our portfolios are poised to benefit from stabilization in the credit turmoil that has plagued the fixed income markets.

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