Still gloomy

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Debt markets threaten to undermine the Fed's goal of restoring order

WAS that it then? From a shareholder's standpoint, it certainly looked as if the Federal Reserve had administered a miracle cure to stockmarkets with its spoonful of easy money on September 18th. Bankers began to talk of the worst being over and done with. In the debt markets, however, a more jaundiced view prevails. Lingering pessimism—in overnight money markets right along the yield curve to long-term bonds—is likely to make the Fed's task harder as it seeks to revive the economy.

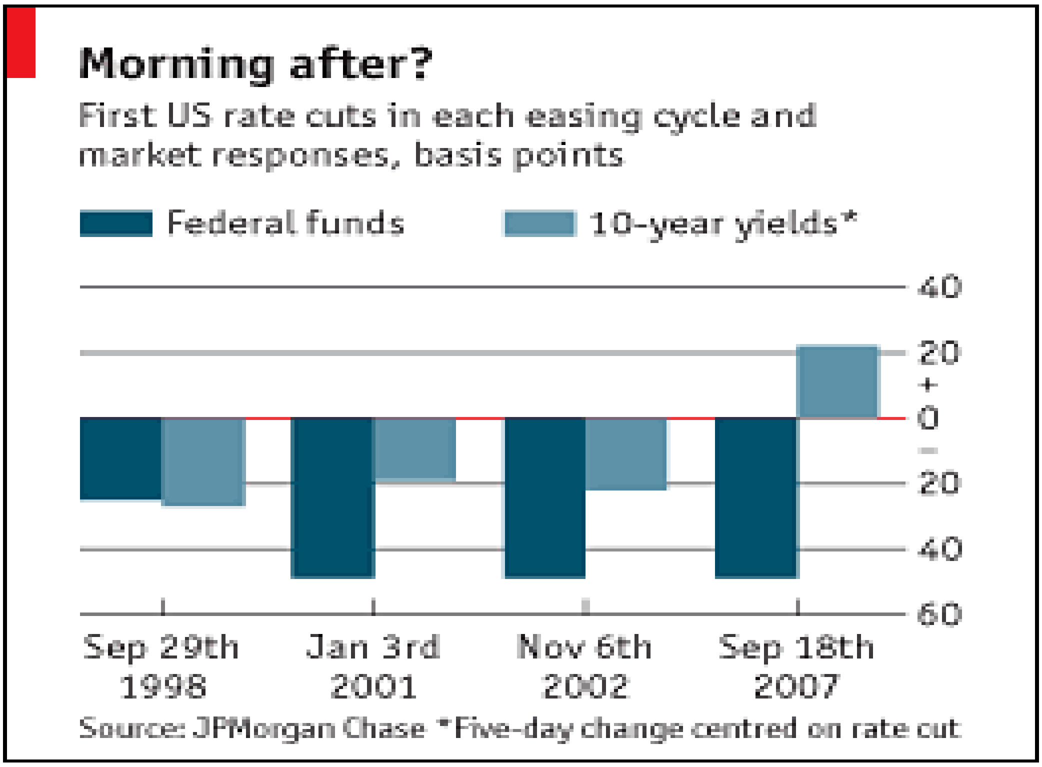
For one thing, the reaction of America's bond market to the interest-rate cut was different from previous rate-cutting cycles (see chart). Instead of falling, as they have in the recent past, ten-year bond yields rose, as investors fretted that the Fed's largesse would stoke inflation. In America and the euro zone yields came off their highs on September 25th, when weak economic data eased inflationary concerns. But economists polled by Bloomberg still expect ten-year yields in America to remain above their levels before the rate cut.

That does not bode well for American mortgage rates, which tend to rise along with long-term Treasury-bond yields. Indeed, the price of a 30-year fixed-rate mortgage has risen by seven basis points since last week, according to bankrate.com, a personal-finance website. That raises concerns about how little the Fed's rate cuts may help the housing market.

Elsewhere, banks continue to find it hard to get funding from other banks over short time-periods, because of their over-stretched balance sheets as a result of America's subprime mortgage crisis. The London Interbank-Offered Rate (LIBOR) in dollars, euros and sterling at overnight and three-month maturities remains higher than normal. Even future rates do not indicate much hope of improvement. Last week, LIBOR traders expected sterling rates to fall to 5.96% by the year-end from 6.35% today. Now traders still expect a drop, but only to around 6.16%.

Like the ten-year yields in America, higher LIBOR rates affect mortgage rates in Britain. Although mortgages are linked to the Bank of England's official rate, which has not changed since July, high-street banks partly fund their loans using LIBOR. If the rate moves up, or does not fall as much as expected, banks are likely to pass on the cost to mortgage borrowers.

Companies, too, are likely to be affected. Corporate-bond markets have re-opened since the Fed cut rates. But given the reluctance of banks to lend, those firms that need ready cash in short-term markets such as commercial paper are likely to feel the squeeze. “Those companies who last rolled over their short-term debt in July are likely to be in for a rude shock when they try to do so again in December,” says John Wraith of the Royal Bank of Scotland. Prepare for a long convalescence.


Morning after?
First US rate cuts in each easing cycle and market responses, basis points
Federal funds
10-year yields*
40
20
+
0
–
20
40
60
Sep 29th 1998
Jan 3rd 2001
Nov 6th 2002
Sep 18th 2007
Source: JPMorgan Chase *Five-day change centred on rate cut